

THE FINANCIAL IMPACT OF SHIPBUILDING
CLAIMS UPON LITTON INDUSTRIES

Jerome Vincent Diekemper

NAVAL POSTGRADUATE SCHOOL

Monterey, California



THESIS

THE FINANCIAL IMPACT OF SHIPBUILDING
CLAIMS UPON LITTON INDUSTRIES

by

Jerome Vincent Diekemper

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L. Darbyshire

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The Financial Impact of Shipbuilding
Claims upon Litton Industries

by

Jerome Vincent Diekemper
Lieutenant Commander, United States Navy
B.S., University of Illinois, 1967

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I. INTRODUCTION

The problems contributing to the incidence of shipbuilding claims and their resulting consequences are not of recent vintage. The Navy had been entangled in disputes with private shipbuilders at least since 1862. On 9 September of that year, a contract was signed for a side-wheel steamer to be built within 176 days at a cost of \$75,000 plus \$500 to be paid to a boiler manufacturer. Due to changes introduced by the Navy and delays caused by the boilermaker, the ship was on the ways for over a year and cost overruns amounted to \$16,000; \$5,000 of this amount was claimed by the Navy to be its responsibility. The remaining costs were charged against the contractor who ultimately went bankrupt [1].

The more recent conflict, in which the Navy has been involved with its major shipbuilders, is of far greater monetary proportion but of seemingly equal financial hardship for many of the contractors. Even though most of these 12 "major" shipyards are associated with large conglomerates, they continue to bemoan the extreme fiscal constraints to which they are subjected while having to endure the complex and time-consuming claim settlement process. Clearly it is a matter of concern to the Naval organization, if it wishes to maintain a broad based industry capable of producing its modern warships.

It is the intention of this author to explore the influence of the claims procedure upon the financial stability of one such company-Litton/Ingalls. The discussion will consider eight successive "milestones" which reflect an assessment of the financial hardships as reported by this contractor over the last ten years. The "milestones" will include a descriptive analysis of the factors contributing to the difficulties threatening at the time, the efforts of the company to anticipate and counter these infringements on its "health" and the Navy's alternatives weighed in its dealings with the contractor. These claims impact not only upon the company's business relationship with the Navy, but often interfere with the conduct of operations associated with other product lines.

It is not intended to discuss the numerous reasons for the increased incidence of the claims, but rather the effect of such claims upon the parties involved. For further enlightenment on the causes of claims, the reader's attention is directed to presentations by Commander Art Meiners [2], Mr. Fred O'Green, President of Litton Industries, Inc. [3] or Admiral Hyman G. Rickover [4].

It must be noted at the onset, that review of volumes of literature relating to dealings with Litton/Ingalls and discussions with DOD personnel indicate an apparent reluctance of the company to fully substantiate the reported impairment resulting from the claims. It is felt that this hesitation is a result of either a company effort to prevent inadvertent disclosure of corporate data (concerning matters which are

not related to Government contracts) to the Navy and/or competitors or a direct attempt to conceal facts which might weaken the plea for monetary relief for the shipbuilding division while the corporation, as a whole, is prosperous.

1. Kidd, Isaac, Jr., ADM, USN, "The Procurement Claims Problem," United States Naval Institute Proceedings, v. 101, #9/871, p. 27, September 1975.
2. Meiners, Arthur C., CDR, USN, Shipbuilding Claims--What Are They and What Can We Do About Them, Speech Presented at the Fifth Annual Department of Defense Procurement Research Symposium, Monterey, California.
3. O'Green, Fred, President, Litton Industries, Department of Defense Appropriations for 1973, Hearings before a Subcommittee of the Committee on Appropriations, House of Representatives, Ninety-Fifth Congress, First Session, Part 4, p. 312, 1977.
4. Rickover, Hyman G., ADM, USN, Memorandum for the General Counsel, Office of the Secretary of Defense, Subject: Use of Outside Counsel to Assist the Navy in Defending Against Shipbuilding Claims, 26 July 1974.

II. BACKGROUND

Shipbuilding claims have experienced a rather rapid growth over the past ten years. In 1968 the amount of existing claims was \$68 million. By 1971, this figure climbed to \$1 billion and as of April 1978 peaked at \$2.69 billion. Accompanying this increase was a change in the "attitudes" expressed in the claims. Prior to mid-1975, about 50% of the claims were submitted for hard-core changes and about 42% for delay and disruption; after mid-1975, this trend reversed with only 20% attributed to changes while delay and disruption claims swelled to 70% of the total [1]. This trend is significant in that the hard-core changes are readily documented by the contractor with the presentation of accounting data supporting labor and material costs. Delay and disruption costs, however, are more difficult to resolve in that the amounts assigned are often the result of subjective decisions which contribute to weak or non-existent substantiation in the accounting records. Consequently, in recent years, contractors have been faced with the dilemma of having to absorb the steadily rising costs until such time as the claims can be resolved.

The growth of Litton/Ingalls' claims was no less spectacular--from \$3.5 million in 1970 to \$504 million in 1975 and finally to \$1.09 billion in 1978 with only 13% of the final amount attributed to hard-core changes [2]. As an insight to

the overall gravity of the situation, one must consider the general areas of concern to the shipbuilder. In addition to absorbing the costs of material and labor, which are included in the claim, the contractor must expend considerable energy and finances to pursue a settlement. Although the first element of the LHA claim arose in 1972, it was not until April 1975 that the company presented the proper documentation to support the allegations. The final portion of that claim was finally documented during September 1977. Consequently, the slow rate at which this claim could be processed has resulted in significant expenses for the corporation and the Navy. It has been estimated, that over the life of the claim issue, Litton/Ingalls will have spent slightly more than \$50 million on claim litigation and processing costs. This expense, if correct, assumes substantial proportions when one realizes that it exceeds the company's cumulative reported net earnings of \$49.492 million for the period 1972 to 1976. However, these costs do offer a tax deduction.

Additionally, information presented by the company indicates an impact on its fiscal position in three other areas--lending difficulties, stockholder apprehension and cash shortages which might have curtailed investments in more profitable endeavors. As the unreimbursed expenses for labor and material increased, the company reported increasing limits on its necessary borrowings to maintain performance; in view of the dim prospects for recovery of some of these costs, the lending banks expressed doubt about the company's ability to

conform to future loan agreements. This predicament stemmed from anticipated violations of lending covenants. It is of interest to note that a study completed in December 1977 compared Litton, Inc. to industry standards published in the ALMANAC OF BUSINESS AND INDUSTRIAL FINANCIAL RATIOS. The various product lines promoted by Litton were equated to 14 identifiable industries for which financial ratios were listed in the ALMANAC. The percentage of each product line's contribution to Litton's total sales was multiplied by the respective industry ratio. These 14 figures were then added for each of the ratios to derive a simulated conglomerate ratio against which the published standards could be compared. Included in the six indices computed for Litton were the Current and Total Liabilities to Net Worth ratios both of which had been included in recent Credit Agreements. In all areas but one, Net Sales to Net Working Capital, Litton met or exceeded the industry standards from FY 73-FY 77 [3].

Litton experienced the growing disenchantment of the stockholders with fading growth potential in early '68 when its stock fell 18 points in one week and subsequently to one half of its 1967-1968 high of \$120.38; this price decline closely followed the report of the first earnings decline in 57 quarters. A review of Litton's annual reports finds such phrases as "Litton concluded fiscal year 1972 in a sound financial position....", "The Company maintains the position that a final court decision based on equity should result in full recovery of all LHA and DD costs" (1976) and in the

report for the nine months ended April 30, 1978, which disclosed the proposed settlement of the claim, "Litton now looks forward to applying its full resources to the broad-based profit growth it is already demonstrating." All of these assurances were obviously intended to sustain necessary support from the investors; however, there are indications that these glowing commentaries may have been less than totally forthright and indicative of the situation at that time. In May 1977, the SEC ordered an investigation of financial information presented in Litton's filings with the SEC and stockholder reports since 1972. There was concern for the manner in which the company had handled reporting of claims and potential claims, allocation of costs between military and commercial contracts and statements on the income, revenue, assets and liabilities. Although the scope of this inquiry was of a rather broad nature, this scrutiny by the SEC combined with past examinations of the company's policy on reporting claims, would do little to support the impressions of well-being previously presented to the stockholders.

Since its creation, Litton had prided itself on its growth through acquisitions. Within the first three years of its existence, acquisitions accounted for approximately 88% of its growth. From 1960 to 1968, the company acquired 103 firms for a price of \$846.4 million. These purchases were made predominantly by the use of Litton stock as the medium of exchange. In recent years, this growth rate has been tempered considerably. Despite the apparent change of

company policy toward development of presently controlled product lines, Litton has advertised the cash flow deficiency generated in its shipbuilding endeavor to be highly restrictive in the execution of corporate goals. There have been numerous cash flow schedules prepared, both in the company's fiscal year plans and in various DOD and GAO studies. These projections were subject, of course, to the changes in payment schedules occurring over the life of the LHA/DD 963 contracts. Nevertheless, cash flow shortages of varying magnitudes have existed within the shipbuilding division for a great portion of the time; however, without extensive knowledge of the company's long term investment intentions, it would be difficult to arrive at a firm conclusion on the future impact of the cash shortages.

As the second party in this ongoing dispute, the Navy has also suffered repercussions in that it has lost credibility with the Congress and present administration. Congressman Les Aspin (D-Wisc.) and Senator William Proxmire (D-Wisc.) have maintained a very close surveillance on the Navy's attempts to ease the contractor's burden; this attention was directed at preventing a "bail out" of the shipbuilder. In 1972, Mr. Aspin expressed concern that a change to the LHA delivery schedule "appears that the Navy has arbitrarily given Litton a gift of \$3 million of the taxpayer's money" in lost liquidated damages [4]. In 1974 and 1975, he again attacked the Navy for providing additional money to the contractor. The Navy's attempts to include in the FY 76 budget,

\$100.9 million for possible future claim payments to Litton, were met with charges of being "a stupid mistake which cripples their (the Navy) negotiating position" [5].

In mid-1972, Senator Proxmire called for GAO and SEC investigations of Litton's ability to financially support the completion of shipbuilding contracts. His allusion to an impending financial crisis within the company was answered by a Litton spokesman who stated that the company is "capable of supporting all cash requirements" [6].

In March 1978, President Carter disclosed a 5 year shipbuilding plan which included only 70 new ships, a number half of those sought by the Navy. Protests from many levels within DOD were met with countercharges of mismanagement of the shipbuilding programs. During a speech at the Naval War College, Edward R. Jayne, an associate director for national security within OMB, stated that the shipbuilding difficulties were a primary reason for Carter's decision. Furthermore, he added that unless "visible progress" toward better management was made within the next year, the Air Force and Army would again get priority over the Navy during budget planning. Present indications are that a reassessment of the Naval missions and responsibilities may have also influenced the President's action. Nonetheless, the widespread dissemination of the Navy's deteriorating business relationships could hardly be expected to provide a positive outlook for the possibility of a successful reclama to the budgetary reduction.

1. Bryan, C. R., VICE ADM, USN, Department of Defense Appropriations For 1978, Hearings Before a Subcommittee of the Committee On Appropriations, House of Representatives, Ninety-Fifth Congress, First Session, Part 4, p. 155, 1977.
2. Jones, Ron, CAPT, USN, Conversations with Author, Washington, D. C., 29 June 1978.
3. Office of the Assistant Secretary of the Navy (Manpower, Reserve Affairs & Logistics), Litton Claims Study, Appendix F, 9 December 1977.
4. Aspin, Les, REP. (D-Wisc.), Letter to Secretary of the Navy John H. Chaffee, 7 January 1972.
5. "Aspin Assails Navy on Litton Contract", New York Times, p. 11, 1 March 1975.
6. "Proxmire Asks Inquiry into Financial Health of Litton Industries", Wall Street Journal, p. 12, 27 June 1972.

III. DEVELOPMENTS

To fully understand a shipbuilder's proclivity to initiate claims and their influence upon his business structure, one must recall the rather dramatic changes which have transpired within the industry over the past ten years. During the late 1960's and early 1970's, the future of the industry appeared rather promising. Nearly 70% of the ships in the Navy were 20 years of age or older. The Navy was embarked upon replacement of these vessels and budget support for the extensive building program seemed imminent. The Great Lakes ore and grain fleet was an average of over 45 years old and in need of revitalization. Congress was considering and ultimately authorized merchantship building and operating subsidies.

During a discussion of the revised subsidies, President Nixon had conveyed to the Congress his desire to assist the shipbuilding industry. He stated, "We should make it possible for industry to build more ships over the next ten years, moving from the present subsidy level of about ten ships a year to a new level of 30 ships a year" [1]. As a means of accomplishing that goal, he urged the use of multi-year procurement by the government to allow the shipbuilders to realize economies of scale and to be able to operate with lower subsidies.

A. DEVELOPMENT OF THE AUTOMATED YARD

At Litton/Ingalls the outlook was equally auspicious. Ingalls was a shipyard which had enjoyed the distinction of several "firsts" since it was established at Pascagoula in 1938. It had pioneered the use of all-welded steel ship hulls, introduced stabilized antenna platforms for seagoing missile tracking devices, developed non-leaking submarine periscope seals and had produced the first roll-on roll-off container ships [2].

Following an operating loss in 1967, there was doubt about the yard's ability to compete for new business in the forthcoming years. The shipyard management judged the East bank facilities to be too small to accommodate the wider beam ships they expected to be built soon. In addition, the end-launch style of shipways used in this yard was considered to be approaching obsolescence and many of the piers and ten shipways required extensive corrective maintenance prior to further use. To effect the magnitude of repairs necessary would severely interfere with any shipbuilding efforts in progress. As an alternative to updating an aged shipyard plagued with reduced capacity, it was decided to proceed with development of the West bank facility. The choice to proceed with this capital expansion program was supported by five factors which projected the success of such an endeavor:

- a. By being the first to build a yard of the proposed advanced style, it was expected that production would be optimized to such a degree as to allow considerable customer

savings. The competition was not expected to be in a position in which they could or would follow suit.

b. A decision to build immediately would assure the availability of the needed land and would likely elicit financial assistance from the Port Authority, County and State Governments.

c. Making a generous proposal to the labor union prior to the expiration of the present contract might enable the company to get a labor force "locked in" for a relatively long period; additionally, continued use of heavy discipline, when warranted, should break the prevailing "walkout psychology" exhibited by many within the labor force.

d. Commencing these modernization efforts should place Ingalls in a position to be the prime candidate for the LHA program and allow it to meet the necessary delivery schedules.

e. The apparent desires of the Navy to continue the use of Contract Definition could be best satisfied by combining the technical/management capability of the Advanced Marine Technical Division (AMTD) in California with the modular construction¹ capability at Ingalls.

¹Unlike traditional shipbuilding in which the ship is built from the keel up in one position, modular construction brings the work to the workmen on small trolley cars. Each compartment is built and outfitted before it is "stacked up" with others as the major sections of the ship move along the assembly line. The ship sections are finally joined as the vessel approaches the launch area at which time the ship is rolled with the trolley cars onto the submersible launch pontoon.

The sentiment of the company was expressed by Mr. Ellis Gardner, President of Ingalls when he stated, "On the other hand, there is simply no prospect whatsoever of engaging in large-scale Navy shipbuilding total package procurement unless we are prepared to develop the competence and stand the expense of such bidding" [3]. This optimism soon gave way to frustration and despair. In 1965, the Department of Defense instituted the use of Total Package Procurement (TPP) for ship production. The LHA was the first ship produced using this method. The inability to develop equitable cost and risk-sharing data and an incomplete definition of the ship's characteristics foretold the gross inadequacies of the TPP system. Consequently, the Defense Department's decision to enforce the use of this system, despite its deficiencies, is considered to be a primary factor in the incidence of the LHA/DD-963 claim.

The changing economic climate, which developed in the mid-70s and continues today, has raised serious doubts about the future success of Ingalls and the shipbuilding industry in general.

B. PRESENT SHIPBUILDING CLIMATE

The 1973-1974 Arab oil embargo heralded a reduced demand for merchant shipping assets. Vessel orders in the United States were at a peak in 1972, when 48 ships totaling 1.55M gross tons were ordered, and in 1973, when orders were placed for 43 ships equal to 2.02M tons. During 1977, new orders were submitted for only 13 ships (266,000 gross tons) with an

aggregate value of \$582.5 million [4]. Due to the decline in the shipbuilders' orderbook, it is estimated that by 1983, the number of workers, who are employed in the 12 major yards serving the Navy, will decline to about 50% of its present level. An economic model developed for the Maritime Administration indicates that a "multiplier effect" reduction will affect 103,000 workers in industries providing supplies and support to the shipbuilders [5]. A prime consideration of the Defense establishment is the time required to re-man these yards in the event of a conflict requiring the production of ships, boats, landing craft, etc.

In addition to having to cope with the devastating effects of the American economy, the shipbuilders have found that the competition for available new orders has become increasingly strong from countries such as Japan, Taiwan, Brazil and South Korea. A CIA report published in November 1977, indicated that, despite cancellation of 55M gross tons² of tanker orders between 1974-1977, there is approximately 37% of the world oil-carrying capacity considered to be a surplus. Petroleum price increases, world-wide recession and reopening of the Suez Canal had simply decreased the demand for the tankers. Some ship owners were able to convert

²Gross tons (GT) are normally used to measure ship production while ship capacity is commonly measured in deadweight tons (DWT). Ratios of DWT to GT vary from 2.0 for large tankers to 1.0 for passenger ships.

tanker orders to bulk carrier construction contracts to avoid payment of cancellation fees. Consequently, the change in orders along with the recession resulted in a surplus of 10M deadweight tons of those ships in late 1977. Further complicating this overcapacity is the fact that Japan continues to win about 50% of the world's new orders. U.S. companies or their affiliates ordered 25 merchant vessels (each 5,000 DWT+) from Japanese yards during the first ten months of 1977; this is almost twice the number of new orders placed with U.S. yards during the entire year. American and European shipbuilders are unable to compete with the construction prices offered by Japan [6].

During a recent speech to the Southern Governor's Conference, Edwin Hood, Board Chairman and President of the Shipbuilders Council of America, expressed little hope for any improvement in the near future. The clouded future of merchantship construction was further complicated by a drastically reduced Naval shipbuilding program. President Carter's request for FY 79 alone had declined from 31 to 15 new ships. Mr. Hood called attention to the lack of a coordinated national policy to preserve an effective shipbuilding industrial base. He faulted the government for its failure to recognize the adverse outlook for the industry and its employees. He stated, "It seems clear that without a coordinated policy on shipbuilding, the downward trend will continue and inevitably lead to an irretrievable loss of capability in this country with consequent higher prices for ships produced by a reduced resource base" [7].

C. PRODUCTION DELAYS AT INGALLS

The management of Ingalls shared with the industry leaders the grave concern for future utilization of its assets. Of a more immediate nature, however, were three major problem areas emerging with the production of the LHA and DD-963. The first was that of a stable work force. Litton/Ingalls, along with many of the competitors, was faced with a continual shortage of workers in the skilled trades. Data published by Ingalls in June 1974 indicated shortfalls as follows: Pipefitters-120, Electricians/Electronics-279, Welders-143 and Shipfitters-212. These shortages were attributed to superior wage competition from the heavy construction industry and the inability of Ingalls to compensate, at a later date, for early program delays attributed to the Navy. The following data compiled by the Shipbuilders Council of America illustrates the amount by which the national average weekly earnings in the heavy construction trades exceeded those in the shipbuilding industry:

1960-- 2.3%	1973--24.3%
1965-- 7.5%	1974--23.8%
1970--19.2%	1975--18.2%
1971--23.1%	1976--13.1%
1972--22.1%	

Table I

Faced with the requirement to build ships, Ingalls had little choice but to hire available labor resources in an attempt to meet the schedules imposed by the contracts. The average Mississippian is considered to be, by nature, a person who can be quite stubborn and will often do what he feels is best for him despite resultant costs to himself or his family. Consequently, assignment to an unpleasant task, the arrival of hunting or fishing season or the hope for a better job elsewhere could prompt the worker to temporarily abandon his shipyard assignment. Between June 1973 and June 1974, about 15,000 workers were hired at Ingalls; approximately 65% of that number had no previous shipbuilding skills. During this same period, 13,000 workers left the yard with more than 40% having less than 3 months experience i.e. trainees. Considering that total employees in the yard numbered 19,287 on 1 March 1974, this turnover rate would have taxed the most adept production managers even under more ideal conditions. Approximately 69% of the workers leaving the shipbuilding industry utilize their new-found skills in higher paying and less physically demanding jobs [8]. Unfortunately, this trend indicates that the shipyards are often little more than a training ground for more lucrative industries. This retention difficulty along with an often unpredictable absentee rate resulted in manpower productivity rates well below those utilized for initial cost estimates.

Subsequent schedule slippages resulting from the labor shortages became more uncontrollable with the onset of runaway

inflation. The LHA contract stated that 20% of the initial target price would constitute labor costs subject to escalation adjustment while 65% of the target price provided material cost adjustments. These costs were apportioned by percentages over a period shorter than the ultimate contract life. With initial progress falling far below expectation, early costs were less than the apportioned values; consequently, the costs incurred later in the program were greater than the amount which could be adjusted for inflation. The rapid inflation of this period acting upon the "bow wave" of delayed costs proved to be the undoing of any attempts at cost control.

Litton's President Fred O'Green provided several examples during Congressional testimony; from 1973 to 1974, the price of wire rope rose from 34¢/foot to 60¢/foot, a 76% increase; steel shot (ton) increased from \$176 to \$347, a 97% climb and copper cable showed a 71% price increase going from \$1.10/foot to \$1.88/foot. He added, "Looking at the effect of inflation another way, we use 800,000 feet of copper cable in each DD and 2 million feet in each LHA. It now costs us \$624,000 more for cable on each destroyer and \$1.56 million more on each LHA. This is a 71% increase in price, compared with a 22.7 percent allowance in the material index" [9]. The material index to which he refers is the Material Index for NavSea Steel Vessel Contracts which provides a basis for determination of escalation payments. The index rose from 128.9 in 1973 to 159.6 in 1974. A more comprehensive

explanation of the formulation and use of this and other escalation indices is available in a thesis by Ippel [10].

Subcontractors were also feeling the economic crunch. A shortage of critical raw materials caused an increased response time for delivery of products to the prime contractors. Consequently, the shipyards were faced with delays of a few weeks up to nine months for receipt of needed materials (valves, electrical cable, tubing, etc.). The unchecked inflation resulted in the suppliers providing their materials with the agreement that they receive "price in effect at time of delivery." The effects of the spiraling prices were felt throughout all industries, but they must have proved most frustrating to Ingalls as they saw themselves accomplishing less work but spending more to complete it.

The third problem the corporation encountered was a lack of overall management/coordination of the shipbuilding endeavor. The Advanced Marine Technical Division (AMTD), which was located in Culver City, California, was responsible for the design and engineering functions. This division displayed a definite orientation toward the aerospace style of production. Plans were drawn with strict tolerances which could not be duplicated in a marine environment. During initial fabrication of the first components, it was discovered that the steel had been cut to such precise measurements that there was insufficient excess to allow welding. The geographical separation of the "designers" and the "builders" served only to compound the ill feelings between the groups. Mr. John Williams, Vice

President in charge of Production at Ingalls, characterized the early misunderstanding as one of "having competent aerospace designers who knew little about building ships and capable shipbuilders who were unfamiliar with aerospace design techniques."

When Ingalls began shipbuilding operations at Pascagoula in 1938, some 23 years before their association with Litton, the yard was erected simultaneously with the signing of a contract for the first four C3 cargo ships to be built in that facility. Ingalls was successful in producing ships within a new yard which was still under construction. Perhaps it was the memory of that past endeavor which spurred a similar attempt with the West bank facility. Unfortunately, the complex nature of this "yard of the future" was not nearly as forgiving as its East bank predecessor. The advanced technology inherent in the modern warships required much greater attention than Ingalls had anticipated. Not surprisingly, they discovered early on their inability to cope with the demands of three immense, yet intricate, concurrent developments--a shipyard and two classes of ships. The move in 1972 to unite the East and West bank resources into a common effort and the relocation of the AMTD from California to Mississippi resulted in an elementary, yet tangible, improvement in their endeavor. Today, both the Navy and Litton agree that the yard is performing in the manner for which it was designed i.e. modular construction of large numbers of ships utilizing advanced automation.

As later chapters elaborate on specific events and decisions instrumental to the impact of the claims upon Litton/Ingalls, it is important to remember that total responsibility for the claims cannot be placed solely upon the Navy and/or the shipbuilders. Inflation, the oil embargo and skilled worker shortages are just three of the many contributing causes which have aggravated the claims incidence and settlement; however, these same three are beyond the control of either of the concerned parties. It is true that better planning and execution by the contractor or more equitable contract clauses offered by the Navy might have tempered the blow of these elements; yet, their very existence has often been blamed for the increased magnitude of claims which may or may not have arisen under more stable conditions. The bottom line is costs--reduce the uncompensated costs for contractors and claims should diminish. Failing to accomplish that goal, it is necessary to consider how severely the costs will infringe upon the corporations' operations both in shipbuilding and other divisions. This is the intent of subsequent chapters.

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9. Ibid., p. 1007.
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IV. FINANCIAL MILESTONES

Reducing the Litton/Ingalls claims against the Navy has proven to be a lengthy and highly emotional issue. This yard, perhaps more than any others serving the Navy, has associated the shipbuilding claims incidence with their on-going financial shortfalls. If one were to depict the developments over the past ten years as a graphic presentation, it would be possible to detect highs and lows as the intensity of the contractor's protests rises and subsides. These highs are the milestones which will be discussed in this chapter. They should be viewed as instances when the corporation's financial liability was perceived to be most acute.

Presentation of each milestone will include the events preceding it, the alternatives and/or decisions with which it dealt and the future impact of its occurrence. The events associated with each milestone are the result of Navy actions, company maneuvers or a combination of both. Nevertheless, the thread of commonality is the possible financial disaster reportedly haunting Ingalls.

A. CONTRACT AWARD

The first milestone is that of the awarding of contracts. The authors (MEINERS, O'GREEN, RICKOVER), previously mentioned as substantial sources of claim data, all include some aspect of the contract as a "cause" for the incidence of the claims.

However, it is more than that alone. Specific clauses, such as escalation, Total System Responsibility and methods of payment, were perfectly valid when agreed to by the contractor. Subsequent developments, such as inflation, when viewed in conjunction with provisions of the contract, placed upon the shipbuilder substantial fiscal responsibility not intended during the contract award.

As stated earlier, the time frame of reference is the past ten years. Within that period, contracts were signed with Ingalls for the production of four ammunition ships (AE 32-35) awarded March 1968; three nuclear submarines (SSN 680, 682, 683) awarded June 1968; nine LHA (LHA 1-9) awarded May 1969; 30 destroyers (DD 963-992) awarded in 1970 and four additional destroyers for the Iranian Navy (DD 993-996) awarded March 1978. The first two classes were built in the old East bank facility while the latter three are under construction on the West bank.

Even though claims have arisen on all but the last group, the LHA claim far outweighs those of the earlier ships. At the time of their settlements in May 1976 and September 1974 respectively, the SSN had a claimed value of \$31.5 million and the AE claim was set at \$35.9 million. The claimed value of the SUBSAFE claim reached \$140.2 million prior to its resolution in February 1978. The Navy ultimately paid \$87.6 million to liquidate these three claims. The LHA issue (including DD-963 impact) peaked at \$1.09 billion and resulted in a \$312 million proposed settlement figure. Consequently,

the analyses throughout this chapter will concentrate on this large claim resulting from LHA construction. Claims arising from other units will be introduced when pertinent to the point of discussion.

In early 1968, Litton was involved in the first stages of construction of the new West bank shipyard; this facility was financed primarily by the \$130 million tax-free state bonds which had been sold by Mississippi in an effort to lure Litton away from its alternate site in Florida. Over the years, there have been a wide range of figures promulgated stating the amount of Litton's out of pocket investment in the yard. A 1969 FORBES article estimated Litton's initial investment at \$3 million [1]. Although Litton has never officially divulged the cost of establishing the yard, company representatives have suggested that the capital expenditure amounted to nearly \$600 million, including the \$130 million from the bond issue [2].

Prior to the start of shipyard construction, it had been announced that Litton was successful in its bid to procure the production contract for approximately 30 Fast Deployment Logistics (FDL) ships to be built at a cost of \$1.4 billion. It was envisioned that this ship would "enhance U.S. military rapid deployment capability by providing a high speed, flexible, sealift force capable of rapid overseas deployment of tactical land force units in conjunction with airlift" [3]. It was the prospect of mass production of this line of ships which enhanced Litton's decision to proceed with the "Shipyard

of the Future". When Congressional funding was omitted for the FDL thereby cancelling the program, Litton immediately diverted its energies to securing the LHA contract.

1. LHA Contract

The construction of a new class of complex warship within this untested modular concept shipyard was in itself a formidable undertaking. A third element, the type of contract, could add another unknown to the equation. The LHA would be the first class of ship to be built using the Total Package Procurement model. With this approach, the contractor was responsible for the design, development and construction of a large number of ships to be delivered over a period of years. The administration of this contract would differ from past procurement actions in that no drawings were subject to Navy approval, any discrepancies in the final specifications were the contractor's responsibility and Navy approvals were to be held to a minimum [4]. Essentially, the contractor was told to design a ship to carry out a mission and determine how many were needed for that mission; in turn, the Navy would keep its "hands off".

In the case of the LHA, a basic concept of the performance expected from the ship was presented to Litton, General Dynamics and Newport News with the intention that each formulate a design to meet the expectations. Each yard was awarded a fixed price contract for this effort; Litton's contract paid \$6.4 million.

Following four months review and negotiations with the contractors, it was decided in May 1968 that only Litton

was eligible to continue its attempt to secure a production contract. It must be noted that the Source Selection Evaluation Board found none of the three proposals to be satisfactory; however, it felt that Litton's was closest to the envisioned design. Litton's proposal called for production of six ships at a price of \$104,566,182 each.

In August 1968, Litton was directed to submit a revised price proposal based on the technical corrections which had been made to the original plan and a change to a nine ship package. Their October resubmission included price adjustments for the changes and for their own original proposal. This new figure was rejected; Litton then submitted another price supposedly reflecting additional costs due only to the changes. This figure was identical to that offered in October. Through the latter part of 1968 and early 1969, meetings between the Navy and Litton continued in an attempt to include all technical requirements necessary to meet the Navy's needs and to arrive at a stable price.

This continual changing of design would later be presented by the contractor as a basis for the magnitude of his claims. Litton charged that the short time period allowed for the changes did not allow proper study of the effects on the total system i.e. how much extra they would cost to incorporate. Litton contended "With these (design) studies progressing but incomplete by the date of award of the contract, there was no way in which either the contractor or the government could predict the requirements for changes which

would grow out of the results of such studies. Nor could the company have taken the results of such studies into consideration as determining any portion of the contract price" [5] (emphasis added). The contractor felt that he was bidding on a ship of unknown dimension and price. Nevertheless, he continued to negotiate with the Navy.

On 31 January 1969, a Pre-Negotiation Clearance was requested by the Navy negotiating team for the following amounts:

	LITTON	NAVY	[6]
Target Cost	\$1,015,516,512	\$897,129,526	
Target Profit	\$ 91,396,486 (9%)	\$ 86,124,434 (9.6%)	
Target Price	\$1,106,912,998	\$983,253,960	
Ceiling Price	\$1,218,619,814 (120% cost)	\$1,076,555,431 (120% cost)	

The Chief of Naval Material granted conditional approval which directed the negotiators to consider the use of either a Fixed Price contract with successive pricing targets (FPIS) for all ships or a Cost Plus Fixed Fee (CPFF) contract for the lead ship with Firm Fixed Price (FFP) for following ships. The reasons for this direction included a lack of competitive climate, the uncertainties of cost data associated with a new yard and the successive increases in the contractor's price estimates. The per ship cost estimate (for a nine ship package) had increased 29% from his original offer.

When the Total Package Procurement method was instituted by Secretary McNamara in 1965, his directive included

that fixed pricing should also be used for major weapons procurements. This instruction remained effective in 1969; consequently, the LHA contract, which was signed on 1 May 1969, was an FPIS contract with final pricing negotiations to occur approximately 34 months later. This method would allow final prices to be established based on the cost information gained during the early stages of production. The initial cost per ship was set at \$112.5 million with 9 ships included in the contract; the first was scheduled for delivery 47 months later.

Two provisions included in the contract had significant subsequent impact upon the contractor's financial position. The payment provision was uncharacteristically composed of two different payment methods. During the first 40 months or until LHA-1 was delivered, there would be little physical progress recorded due to the concentration on final design efforts; therefore, the contractor would be paid for all allowable costs. Following the expiration of that period, the payments would then be based upon percent of physical progress; during the early months of progress payments, the amount remitted to the contractor would be adjusted to account for any difference between what he had been paid under the cost system and what he would have been paid under a progress system.

As mentioned earlier, the government had agreed to maintain a "hands off" attitude in the execution of the contract. As a corollary to this understanding, Article XXX--

The Total System Responsibility Clause was included in the contract. Essentially, it required that the Contractor "assume full responsibility for delivering LHA ships that meet or exceed the performance requirements/capabilities of section 3 of such contract specifications" [7]. Any changes, which would be required by the contractor in order to carry out the contract, would be accomplished at no cost to the government and with no change in the delivery schedule.

Two other contracts, which were signed by Ingalls during this same period, ultimately expanded the limits of claim liability. In October 1968, Ingalls contracted to build seven merchant ships, four for FARRELL Lines and three for AMERICAN PRESIDENT Lines (APL). A fourth APL ship was later included in the agreement. It was planned that the relative simplicity of these eight ships would provide an ideal opportunity to initiate the "assembly-line" concept prior to the start of LHA construction. Unanticipated delays on the first ships prompted Ingalls to build four of them in the old East bank yard rather than risk additional interference with the much-delayed Navy contracts.

2. DD-963 Contract

On 23 June 1970, Litton won a contract to build 30 destroyers. The award of this contract was surrounded by considerable controversy. The DD-963 class was procured utilizing the Total Package Procurement method. Following the evaluation of six initial bidders, contract definition contracts were given to Bath Iron Works, Litton/Ingalls and

General Dynamics. The latter party was eventually eliminated; following several rounds of bidding, each of the two remaining submitted a fourth and "best and final" offer in March 1970. The requirements called for bids based on an FPIS procurement of 30 ships. Although the base cost presented by Bath was \$95.6 million lower than Litton's, the final cost was higher. The difference was a result of each contractor's estimate of inflation during the length of the contract.

Litton computed a \$143.7 million overrecovery of escalation while Bath derived a \$146.3 million underpayment [8]. Following adjustments for their estimates, Bath's target cost was \$61.3 million per ship compared to Litton's \$54.9 million.

Following the announcement of the contract award, Bath filed protests stating that they had been misled as to what costs would be considered in awarding the contract. Documents presented by the Navy indicated that Bath had, in fact, understood the bid process; consequently, the contract was given to Litton, the low bidder!

At the onset, Navy negotiators felt that Litton's pricing was "very tight"; however, consideration of several factors indicated an apparent ability to meet the goal. Adding the 963 program to the already large LHA package would permit a wider spread of the overhead. Ingalls, being an entity within a corporate organization, should enjoy less management expenses than Bath and labor rates were lower in Pascagoula than in Maine [9].

Senators Smith and Muskie of Maine attempted to add to the defense procurement authorization bill an amendment

which would force Litton to sub-contract production of half the ships. Despite speeches to the Senate, appeals to the Administration and GAO investigations of the procurement process, the amendment was stopped by the Senate Armed Services Committee, whose chairman was Senator Stennis of Mississippi.

Litton's repeated success in securing these contracts for 47 ships indicated the three customers' willingness to test the capabilities of the new yard. It was expected that this revolutionary style of ship construction would breathe new life into the American shipbuilding industry and the U.S. Navy's warfare capabilities. This anticipation soon turned to doubt.

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3. Oldfield, Barney, COL, USAF (Ret.), "FDL-Ship to Shape Sealift's Future," Nato's Fifteen Nations, p. 1, February /March 1967.
4. Office of the Assistant Secretary of the Navy (Manpower, Reserve Affairs & Logistics), op. cit., p. 20.
5. Litton Industries, Memorandum in Support of Request for Contract Restructure Under PL85-804, v. II, p. 50, 29 June 1976.
6. Office of the Assistant Secretary of the Navy (Manpower, Reserve Affairs & Logistics), op. cit., p. 31.
7. Naval Sea Systems Command, LHA Contract #N00024-69-C-0283, Article XXX, Total System Responsibility Clause, May 1969.
8. Staats, Elmer B., Comptroller General of the United States, Letter to Bath Iron Works Corporation, %von Baur, Coburn, Simmons and Turtle, 21 December 1970.

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Subject: DD-963 Procurement, 15 April 1970.

B. MEMORANDUM OF AGREEMENT

Following the LHA contract award in May 1969 and through most of 1970, the contractor was involved with the culmination of the ship design. Problems, which arose during this period, developed into program delays and provided the basis for the initial claim against the LHA. As previously mentioned, the contract provided that the contractor assume full responsibility for the design and production; the Navy's prime function was to ensure that any changes introduced by the builder would not hinder the ship's overall intended mission.

The major goal during this period was the attainment of a system design baseline which would have Navy approval, but progress began slipping in late 1969. In order to regain lost time, the contractor proposed several changes to the ship. The Navy review of these suggestions was completed in September 1970 and Litton was presented with 2,905 documented comments on the drawings and specifications [1]. Following an abbreviated survey of the documents, Litton made an announcement which confirmed Navy suspicions that the start of production would be delayed. In December 1970, the corporation confirmed that LHA-1 would be delayed ten months and that they would be submitting a Request for Equitable Adjustment (REA) to the contract price.

In a document submitted later in the program, Litton categorized the four problems which had plagued them during this period.

1) Studies incomplete at contract award/studies required after award. These included contemplation of rearranging the medical facilities, changes in the model of air search radar, design problems with electronic counter measure systems, landing craft handling and stowage tests and ship propulsion (rudder and screw location) studies.

2) Changes in requirements after award affecting contractor design and development. These dealt with additions to the radar/IFF system, changes in the radio communication systems which hindered interface with subcontracted equipments and revisions to the design of the flight deck island, commissary and living spaces, cargo handling system and various habitability improvements.

3) Lack of information concerning government furnished equipment (GFE) at time of award. This involved lack of technical data on many electronic systems which were predominantly GFE, computer software information, weapon systems capabilities and ship manning data.

4) Inadequate identification of the magnitude of potential design problems at time of award. These consisted of previous problems encountered with a conventional style stern-gate (i.e. one hinged at the bottom), requirements for contractors to comply with shock mount designs known to be inadequate and a lack of information available on required performance of lightwater fire fighting systems [2].

In early December 1970, another dimension was added to the already strained relationship. The Navy reduced from

nine to five the number of LHAs it would purchase. The original need for nine ships had been based on the Navy's overall requirement to transport 1 2/3 Marine Amphibious Force (MAF) (approximately 56,400 personnel). However, fiscal constraints established during formulation of the FY 72 Program Objectives Memorandum (POM) limited the troop size to 1 1/3 MAF (approximately 45,100 personnel). To comply with this reduction, only five LHAs would be needed to assist in the troop lift; the cut was approved by the Deputy Secretary of Defense on 5 December [3].

Article VIII of the contract had given the Navy the opportunity to cancel all ships in program years subsequent to the FY in which the notice was given. It had originally been computed that the average unit cost would range from \$284 million for one ship to \$112.5 million for a buy of nine. In accordance with a schedule included in the contract, Litton was entitled to a maximum payment of \$109.7 million for cancellation of the last four ships.

In view of the significant changes (i.e. reduction of program size and delay of production) which had occurred since the contract was signed, the Navy and the contractor agreed to sign a Memorandum of Agreement. The agreement implemented, on an interim basis, certain revisions to the terms of the contract without prejudice to the rights of either party. Specifically, the contractor was directed to perform the work following a provisional schedule which delayed the delivery dates as follows: LHA-1 12 months, LHA-2 13 months, LHA-3,

4,5 14 months. In addition, he was to submit by 29 October 1971, a Reset Proposal which "firmed" the target cost and price, ceiling price, delivery schedule and the sharing ratio.

The Memorandum also introduced changes which would hasten the completion of all plans and designs. Specific time limits were placed upon each party to speed confirmation of proposed changes; the Resident Supervisor of Shipbuilding (RESSUPSHIP) was given authority to consent to any remaining subcontracts and program reviews were reduced in scope [4]. These revisions attempted to improve some of the procedures which had presented the most serious initial delays for the builder. Essentially, the Agreement was intended to recognize and correct those elements which had prompted a deterioration of the business relationship between the two parties. It was hoped that this effort would alleviate further delays and disputes involved with the LHA program. The Agreement was to remain in effect until 31 March 1972.

At the same time the contractor was attempting to substantiate the schedule and costs in compliance with the Memorandum, the first merchantship under construction in the new yard was encountering difficulties. The condition of the long-delayed AUSTRAL ENVOY, which was launched in June, caused serious doubts among the ranks of the Naval shipbuilding administration. Many of the 240 steel sections failed to fit properly, the deckhouse sagged more than $\frac{1}{2}$ inch, bulkheads buckled, one cargo hold was too shallow, the anchor failed to house properly and the ship was 3 inches shorter

than allowed in the specifications [5]. Despite apparent progress in avoiding as many defects on the following ships, the general opinion was that vastly improved management, along with some luck, was necessary to "debug" the yard in order to avoid similar problems on the upcoming Navy work.

In July, the contractor notified the Navy that the Reset Proposal would not be available until early 1972; he related that key personnel needed to formulate portions of the proposal were also needed to manage the LHA design completion and to initiate the fabrication of LHA-1 in August. This manpower shortage was further complicated by a strike which crippled the yard from August 30 to October 4. Approximately 800 of the 5200 employees at the new facility moved away to other jobs; the recruiting teams estimated that they lost an additional 800 to 1000 prospects during the shutdown. Ben W. Borne, Vice President for Industrial Relations, stated that his goal was a 350 worker per month net increase in order to meet employment levels required by early 1973 [6]. Few in the Navy expected Ingalls to be able to meet that target.

Following a review of business risks on the Litton shipbuilding programs, personnel from the Naval Ship System Command concluded that losses on the merchantship program would range from \$75 to \$100 million; the financial resources available within the corporation indicated that Litton could absorb losses up to \$250 million without impairing the completion of the LHA and DD. Furthermore, the Navy estimated 18 to 24 months late delivery on the LHA with costs exceeding

the contract ceiling price. Their concern was justified when Litton submitted the Reset Proposal in March 1972.

The contractor presented a schedule which indicated that the LHA-1 would be 19½ months late with LHA-5 over 2 years late. Included in the Reset was a REA of \$246.6M to the target cost. This constituted the first "claim" against the LHA and was an estimate of additional costs to be incurred over the life of the program. Much of the increase resulted from a 22.3 million increase in the manhours required to complete construction. Compared to the original estimate of 20.3 million, this new figure (42.6 million) represented more than a 100% increase. Litton attributed the added labor demand to changes and delay during engineering completion, increased labor rates and decreases in the manpower efficiency (learning curve factors). Approximately 39% of the growth was tied solely to changes in the ship design after the initial bid. Consequently, the Estimated Cost At Completion (EAC) for five ships was \$1.05 billion which exceeded the original nine ship contract cost by \$127.5 million.³

In addition to the sought after cost increases, the corporation requested a 20 month extension to the cost incurred

³The original nine-ship contract had a Target Cost of \$922.5M (\$102.5M/ship) and a Ceiling Price of \$1,199.25M (\$133.25M/ship). Adjusting the original contract for the conversion to a five-ship program, including authorized changes and constructive change and delay allowances, raised the Ceiling Price to a maximum of \$1,014M (\$202.8M/ship). However, the contractor's Reset Proposal estimated costs to completion at \$1,050M (\$210M/ship).

payments. It was their feeling that the entire delay of LHA-1 was the fault of the government; Litton gave little consideration to their own start-up problems such as planning inaccuracies and manpower shortages. The company contended that failure to grant this request would result in a \$150 million negative cash flow during the time needed to regain the building schedule. Despite their pleas, the Navy denied the request; additionally, the contractor was informed that an in-depth review of the REA could not be accomplished with the sparse information presented in the March submission [7]. Litton responded with a proposal to present, in July 1972, another submission which would justify their request for extension of the payments.

A synopsis of Litton's financial position in mid-June indicated a likely fiscal year-end negative cash flow of \$90 to \$100 million; it was anticipated that the earnings would show a decrease for the year and this would further aggravate the already irritated stockholders. At the same time, Litton was appealing to various Congressional leaders to provide the relief the Navy refused to grant.

The pressure was clearly upon both parties to attempt an immediate resolution to the matter. In anticipation of possible repercussions when Litton publicly announced its plight in the stockholder's annual report, the Navy considered the alternatives available for a solution. These choices ranged from holding to the current contracts to cancelling some LHAs and/or some DDs or entirely terminating both

contracts. The cost of this latter choice would include about \$750 million for the LHA and \$400 million for DD along with the cost of having to continue operating older and less capable ships [8]. In view of the Navy's strong desire to have these ships built without undue harm to Litton/Ingalls, it seemed apparent that the reasonable choice was a renewed attempt at revising the contract in order to provide an equitable position for both parties.

In an attempt to reach this goal, officials of the Navy and Litton met to discuss specific needs. Litton expressed a dire need for \$41 million prior to the end of their fiscal year (31 July). Roy Ash, then President of Litton Industries, voiced his concern with respect to the influence the shortage might have upon the company's ability to renew short-term credit lines. As a source of immediate relief, discussions centered on two older claims--the AE and SSN 680. The ammunition ship claims resulted from Litton having to correct defective specifications prior to production; Litton initially estimated costs of \$35.9 million when the claim was submitted in April 1971, but subsequent reappraisals reduced the claim to \$31 million. The \$31.5 million claim, which was lodged against the SSN 680,682 and 683 in November 1970, resulted from the alleged late delivery of government furnished steel which was needed to maintain production schedules. Due to the dearth of initial supporting data, the Navy could offer only \$7 million in response to the claims [9]. Subsequent consideration of the two East bank contracts yielded sufficient

cause to increase the payment offer to \$19 million. This offer was refused by Charles B. Thornton, Chairman of the Board of Directors. He held the position that anything less than \$30 million would be of little assistance; he also proposed that the LHA contract be revised to a cost, no-fee basis with Litton accepting no loss.

The differences in negotiating positions continued through late August when the Navy officially rejected the REA on the basis of Litton's failure to specifically identify individual costs associated with the increased cost request. The contractor was promised careful and expeditious evaluation of any claim if it was submitted in the format required by the Changes clause in the original contract. Although the Navy contested the magnitude of the claim, it extended the cost-type payments for 6 months to compensate the shipbuilder for delays deemed to be the result of government actions. The change to progress payments would now occur on 28 February 1973.

In mid-November, the Defense Contract Audit Agency (DCAA) was granted limited access to corporate files in their attempt to provide a more comprehensive analysis of Litton's cash flow difficulties. Meanwhile, attempts to resolve the Reset Proposal and REA disputes continued without success. The government impressed upon the company the need to substantiate present and future financial positions prior to consideration of any appreciable relief. Litton reluctantly provided some of its financial plans.

Based on data provided by the corporate headquarters, the DCAA forecasted a \$26 million corporate cash surplus at the end of FY 73. The cash flow projected for the year, however, would be an outflow of \$147.1 million with \$40.2 of that as a result of the Marine Group operations. These projections were based on the assumption that cost funding would continue throughout FY 73 despite the fact that Litton had been informed that these payments would cease in February [10]. There were several conditions which could impact on the cash predictions; these included any change to the then available \$155 million line of credit, a possible sale of Stouffer Food Products for \$100 million and the need to repay approximately \$136 million of the \$285 million outstanding long term debt while \$38 million was to be renewed and \$111 million rolled over.

The DCAA inquiry did confirm the possibility of a substantial negative cash flow during FY 73; however, the limited access provided made it difficult to predict the probability of such an occurrence and, therefore, did little to break the stalemate between the Navy and Litton/Ingalls.

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2. Litton Industries, Memorandum in Support of Request for Contract Restructure Under PL85-804, v. II, p. 68, 29 June 1976.
3. Kidd, Isaac, Jr. ADM, USN, Hearings on Military Posture and H.R. 12604 before the Committee on Armed Forces, House of Representatives, Ninety-Second Congress, Second Session, Part 2, p. 10588, April 1972.
4. Memorandum of Agreement, LHA Contract, Contract N00024-69-C-0283, 23 April 1971.
5. "Delays, Problems at a New Shipyard Raise Fears That Navy's Fleet Modernization May Be Delayed," Wall Street Journal, p. 42, 9 December 1971.
6. Schoedel, Alan F., "Litton's Two Shipyard Mistakes Reviewed," Journal of Commerce, 16 November 1971.
7. Sonenshein, N. RADM, USN, Commander, Naval Ship Systems Command, Letter to Litton Ship System, Subject: Contract N00024-69-C-0283, Progress Payments and Request for Equitable Adjustment (REA) portion of LHA Proposal, 7 April 1972.
8. Devan, Clarence F., Jr., CDR, USNR, Report on two weeks ACDUTRA 4 June-17 June 1972 performed on Naval Material Command staff, Subject: Synopsis of Litton Situation and Recommendations, p. 1-5, 12 June 1972.
9. Gooding, R. C., RADM, USN, Acting Commander, Naval Ship Systems Command, Memorandum for the Chief of Naval Material, Subject: Cash Flow Problems of Litton Industries, 22 June 1972.
10. Defense Contract Audit Agency, Report on Reivew of FY 1973 Cash Plan Submitted by Litton Industries, Inc., p. 4-7, 10 November 1972.

C. CONTRACTING OFFICER'S UNILATERAL DECISION

Negotiations on the Reset Proposal continued through the fall months and into the new year. In early January, Litton's President and Ned Marandino, President of Ingalls, met with Admiral Kidd, CNM, and other Navy representatives to discuss the present business climate at the shipyard. Mr. O'Green indicated that Litton now had \$456 million tied up in the facility; this total consisted of \$305.5 million invested at the East and West banks, which were now operated as a single unit, and \$150.5 million losses incurred on the contracts in progress. The losses included \$20.5 million on the AE, \$31 million on the submarines and \$20 million on the LHA. The DD-963 was enjoying a \$25 million positive cash flow [1]. Also included were \$133 million of Manufacturing Process Development (MPD) or "start up" costs.

These MPD costs had arisen as an indirect result of Ingalls' decision to build merchant ships in the new yard. The estimates, which had been submitted by Ingalls in their attempt to win the merchant contract, represented the costs associated with traditional construction techniques. When costs in the new facility ran higher, Ingalls treated them as non-recurring, extraordinary costs resulting from the construction of the merchants in the new vice old yard. Since the new yard had been developed for the LHA and DD, part of the \$155 million MPD expenses were apportioned accordingly--\$43 million to LHA and \$90 to DD-963; the remainder was charged to the merchants. From the onset, the Navy refused

to recognize any of these costs as applicable to their contracts. The Navy had, however, allowed \$6 million on the submarine claim, \$1 million on the AE claim and \$19 million for authorized changes on the LHA. A deduction of these amounts from the above claims results in the \$150.5 million loss figure.

Mr. O'Green also addressed an additional claim for \$101.3 million which had been submitted in May 1971. This claim for delay and disruption was later known as the Subsafe or Project X claim. In the early 1960s, Ingalls had contracted to build four nuclear submarines (SSN 621, 639, 648, 652). When the USS THRESHER was lost in 1963, the Navy instituted extensive design changes in order to upgrade the safety factor for all nuclear boats under construction. It was not until mid-1965 that the Navy was able to generate enough information so that a reasonable construction effort could continue. Litton charged that the Navy had applied pressure upon them to fully man the now-revised subs in order to regain lost time. Furthermore, they contended that five Navy surface vessels and 14 merchantships were delayed as a result of increased manning levels on these subs [2]. This claim was summarily rejected by the Contracting Officer for lack of adequate substantiation.

Having presented these specific costs, Mr. O'Green continued to press the Navy for immediate relief to their alleged cash flow predicament. He indicated a need for \$32 million for payment of short-term liabilities which would prevent

violation of a bank-imposed 2.2 current ratio, and future relief for the estimated \$140 million overrun on the LHA contract (\$100 million above appropriated funds plus \$43 million MPD). He indicated that the lending banks were quite displeased with Litton's steadily increasing liability and were hinting at restrictions on any further expenditure of funds in the yard.

One can sense the frustration of these arguments in a verbal exchange recalled by Admiral Kidd, "I (Kidd) told him (O'Green) that we would enter into immediate negotiations and discussions with Mr. Casey, Litton's VP for Finances, to try and find palatable ways to handle their cash flow problem. I told him that in doing so, we would not look with any favor on any approach that wasn't cleaner than a hound's tooth. Mr. O'Green got a little testy at this assertion and told me that such a stand would indicate that I didn't trust Litton. I told Mr. O'Green that that wasn't too wide of the mark because they had been over the past two years of my association with them, somewhat less than convinced that the contract was worth anything. Mr. O'Green harked back to what we heard so many times in the past from Litton to the effect that the contract was really a vehicle with which to get started and that it had needed reforming for a long time" [3].

The Contracting Officer (C.O.) had previously extended the cost-incurred payments to 28 February in the hope that the additional time would permit the parties to reach a long sought agreement on the Reset. Realizing that these efforts would be fruitless, on that date, he exercised his rights in

accordance with the contract's DISPUTES clause. Attempting to unilaterally break the deadlock, he issued the Contracting Officer's Final Decision which addressed delivery schedules, prices, escalation factors and the method of future payments. (For Litton's response see pg. 55.)

The Ingalls management continued to encounter delays which caused the LHA delivery schedule to slip further behind. The latest proposal from the contractor had LHA-1 delivering on 14 March 1975 (23½ months late) and LHA-5 available on 17 December 1976 (32 months late) [4]. This schedule was officially recognized in the Contracting Officer's Decision. By confirming these dates, he accepted seven months excusable delay-six months as a responsibility of the government and one month as a result of the late summer labor dispute which crippled the yard. The remaining slippage was judged to be the fault of the builder. The six month delay had been the basis for the extension of the cost-type payments.

Along with the extended delivery dates, the Decision raised the Firm Target and Ceiling Price to \$795.265 million. This higher price included \$19.3 million for authorized changes and, in accordance with the original contract, \$109.7 million compensation for any additional costs incurred as a result of the cancellation of four ships [5]. The Firm Target Price would also serve as the billing base upon which the future progress payments would be determined. Vessel labor and material, program labor and material and data systems division data were combined to arrive at a percentage

completion based on physical progress. This percentage was then applied to the billing base to determine the cumulative payment due to the contractor. On 28 February, it was determined that the LHA program was 44% complete; further computations revealed that Ingalls had been overpaid \$54.6 million as a result of receiving cost based payments. It had been agreed in the original contract that such a situation would be resolved by Litton withholding payment requests for three months and then paying in a lump sum any remaining balance. This procedure would shortly become the subject of considerable controversy.

The original contract stated that LHA escalation payments would be made for 24 quarters. With the cancellation of four ships, the period was shortened to 20 quarters but later raised to 22 quarters as a result of the six months delay. During previous negotiations, the two parties had agreed that 48% of the Firm Target Price was applicable to labor cost escalation with 44% of the price applicable to material escalation. These respective percentages were then allocated over the 22 quarter period to determine the amount of quarterly costs subject to escalation [6].

Litton's response to the Contracting Officer's Decision was swift. They immediately appealed to the Navy for a deferment on repaying the \$54.6 million. Their weekly costs were slightly more than \$3 million; therefore, they would have received no payments for three months and still owe a \$15 million lump sum debt. The Navy denied this request; Litton then turned to the courts for relief.

The corporation appealed to the District Court in Mississippi based on the "spirit" of the contract which discouraged undue hardship for the contractor. On 7 March, the Court issued a Temporary Restraining Order (TRO) requiring the Navy to continue the cost type payments and to refrain from collection of the overpayment. In early April, the TRO was extended indefinitely. Meanwhile, Litton had appealed the C.O.'s unilateral decision to the Armed Services Board of Contract Appeals (ASBCA); in the process of this action, they listed the LHA claim at a new value of \$376 million.

In October, the Fifth Circuit Court of Appeals in New Orleans awarded the Navy a stay on the TRO. Essentially, the government could refuse to render any additional payments until the case was clarified by the court. Realizing that their cash flow would be interrupted, Litton again sought a reprieve from reimbursement of the overpayment which was now worth approximately \$30 million; the shipbuilder had made sufficient progress to reduce the debt. The company was quick to note that earned escalation, not yet paid, and any claim awards, which they might gain from the ASBCA decisions, could easily exceed the amount owed [7]. At this time, the ASBCA was deliberating the LHA claim along with approximately \$160 million of claims on older contracts (i.e. AE, SSN, Subsafe).

A brief appraisal of the situation provides an insight to the Navy's imminent reply. The LHA was behind schedule, the Reset Proposal for the DD-963 contract was due within a few weeks. Thus far, the contractor had demonstrated his

capabilities by maintaining adequate progress on the destroyer program. The fate of the LHA was before two legal forums, the ASBCA and the District Court of Appeals. The Navy certainly needed the ships; however, it appeared that attempts to reach this end were drawing increasing criticism from the Congress in the person of Representative Les Aspin (D-Wisc.). Consequently, it was paramount that the Navy encourage performance while avoiding the appearance of a "bailout". The Navy could exert a limited fiscal persuasion on Litton by withholding payments; this action could conceivably force Litton to stop work and maybe close the yard.

1. Twenty-One Day Deliberations

The Navy proposed another attempt at reaching a reasonable settlement. The two parties agreed to partake in a 21 day deliberation session during which time the contractor would be paid on the basis of costs incurred. These payments would bear interest at 7 3/4%. The objectives of this meeting included agreement on a maximum price adjustment (cap) to the LHA claim and dismissal of the ASBCA appeals and District Court suit. In return for these considerations, the Navy would grant a deferment of the "debt" payback [8]. This contract modification was formally executed on 29 October 1973 and would expire on 18 November of the same year.

On the same day, Litton submitted its Reset Proposal for the 963. The document reflected that the company had again failed to substantiate their data in accordance with the contract provisions. They simply submitted the Estimated

Total Contract Cost figure with no mention of specific pricing for recommended changes. They were directed to resubmit the offer within 30 days [9].

Meanwhile, the negotiations were progressing very slowly. Ingalls had agreed to submit an initial proposal by 2 November, but as of seven days later had failed to do so. It was felt that the company was experiencing difficulty in reaching a consensus of corporate opinion as to the limits of the offer to be presented to the Navy. The government was also suffering from an internal organizational disorder. The Justice Department had become concerned that this contract modification could interfere with its effort to pursue the claims issue in the District Court. The Office of General Counsel, as a result of the Justice Department interest, halted the payments to Litton on 2 November. Upon learning of that action, the corporation refused to submit their proposal which was already overdue. Following communications between the Secretary of the Navy and Acting Attorney General Robert Bork, the modification was approved and on 12 November the payments resumed. Simultaneously, Litton submitted the proposal.

The company presented a document which they felt resolved all issues pending from the C.O.'s decision. They sought an adjustment of \$144 million; this consisted of \$40 million for changes, \$44 million for 32 months delay, \$20 million for loss of overhead absorption due to LHA delay and a \$40 million increase to escalation payments which was

equivalent to seven additional quarters of escalation [10].

Following initial consideration and comments from the Navy, Litton offered a revised plan on 16 November. The Navy considered this offer also unacceptable. Ingalls had agreed to cap the claim for only six months. If no agreement had been reached by that time, the company intended to reinstate the LHA appeal presently before the ASBCA. Additionally, they contended that any contract modifications, including those which had been previously adjudicated, would be subject to upward revision, but could not be reduced below present Navy offers. In view of the differences in bargaining positions, the Navy realized that the 21 day session might expire without appreciable gain. The payments would be stopped, but negotiations could continue. The loss of the weekly payments might inspire Litton to agree to a settlement more favorable to the Navy.

Among those closely observing the proceedings, there was a feeling that the talks had stalled due to Litton's failure to devise a means by which they could explain to their stockholders and the public, why they would agree to a \$84 million (\$40M changes and \$44M delay) cap when their LHA claim was stated to be worth \$376 million. At no time had they presented any documents which could support that higher figure.

Despite the company's request for a 14 day extension to the talks, the Commander, Naval Ship System Command ordered the payments stopped on 19 November and directed the

collection of interest due and the withholding of progress payments until the previous overpayment had been liquidated. The discussions continued through December and into 1974. Many of the issues, which had been introduced during the 21 day period, were acceptable to both sides; however, the main point of contention was that the decreasing cash flow forecasted for the LHA. Litton held that there must be a zero negative flow for the life of the contract including any necessary litigation period. The Navy requested that corporate personnel provide in writing an outline of their specific needs for continued solvency of the yard. This request was answered with a promise to provide such information by 4 January 1974.

1. Kidd, Isaac, Jr. ADM, USN, Chief of Naval Material, Memorandum for Record, Subject: Debrief of Discussion with Litton Officials on Thursday, 3 January, p. 3, 3 January 1973.
2. O'Green, Fred, President, Litton Industries, Department of Defense Appropriations for 1978, Hearings before a Subcommittee of the Committee on Appropriations, House of Representatives, Ninety-Fifth Congress, First Session, Part 4, p. 349-350, 1977.
3. Kidd, Isaac, Jr., ADM, USN, op. cit., p. 9-10.
4. Woodfin, K. L., RADM, USN, Contracting Officer, Naval Ship System Command, Letter to Ingalls Shipbuilding Division, Subject: Contracting Officer's Final Decision Under Contract N00024-69-C-0283, p. 6, 28 February 1973.
5. Ibid., p. 8.
6. Ibid., p. 9-10.
7. Ingalls Shipbuilding Division, Letter to RADM E. E. Renfro, Deputy Commander for Contracts, Naval Ship Systems Command, Subject: Contract N00024-69-C-0283-LHA Request for Deferment Agreement IAW ASPR Appendix E, Part VI, 12 October 1973.

8. LHA Contract N00024-69-C-0283, Modification P 00016,
29 October 1973.
9. Renfro, E. E., RADM, USN, Deputy Commander for Contracts,
Letter to Litton Systems, Inc., Subject: Contract N00024-
70-C-0275, DD-963 Class Destroyer, Reset Proposal,
7 November 1973.
10. Ingalls Shipbuilding Division, Letter to G. McBride,
Naval Ship Systems Command, Subject: LHA Contract N00024-
69-C-0283, 2 November 1973.

D. LITTON OFFER TO SETTLE CLAIM

On 3 January 1974, Mr. O'Green and Mr. Marandino met with Admiral Kidd, Rear Admiral Gooding (COMNAVSHIPS) and several other Navy contracting personnel. During his review of past LHA negotiations, Mr. O'Green indicated that Litton and the Navy "haven't really started what is required to solve the problem." This remark was later interpreted to mean that the Navy had not approached the Congress for assistance as might be necessary to solve this dispute. He continued by again highlighting Litton's total investment in the shipyard (\$456.3 million) which consisted of \$305.5 million investment and \$150.8 million losses; also mentioned was a \$20 million debt repayment due immediately. The magnitude of the problem, as he viewed it, was such that by 1978 there could be an \$32 million negative cash flow on the LHA alone [1]. It is interesting to note that Litton had prepared projections out to 1978 when the then current schedule called for completion of LHA-5 prior to December 1976.

Mr. O'Green repeated previously offered solutions including reformation of the contract to a cost system, provision for partial payment against the claim and elimination of performance retentions. He also included as alternatives the modification of the DD contract to allow payments above the 105% of cost ceiling (i.e. utilize retentions already earned but not payable under contract terms) or use of advance payments. He remained opposed to any cap on the claim on the grounds that Litton should be paid all they deserve without

limit. The Navy responded by requesting a more specific written explanation of the general issues raised by the Litton officials.

The Navy personnel realized that the numbers presented by the corporation, if accurate, portrayed a rather grim future. Nevertheless, the alternatives for relieving the cash flow shortage required careful consideration. In one respect, the Navy was limited by Congressional amendment to the amount of money that could be provided without prior approval of the Armed Services Committees; on the other hand Armed Services Procurement Regulations (ASPR) dictated the extent of payments allowable to the contractor. Even more confining was the need to maintain a proper public image. Although payments could legally be provided, it was always necessary to avoid any actions which might appear as a "bail-out" of an "inefficient" shipbuilder. In the meantime, the government enjoyed a minor victory when the Fifth U.S. Circuit Court of Appeals vacated the District Court order which had forced the Navy to provide cost-type payments. The higher court ruled that Judge Cox had lacked the jurisdiction to issue such an order.

During a meeting of the same personnel two weeks later, Admiral Kidd informed Mr. O'Green that cash relief might be expected in the form of a loan from the retainage funds or by providing advance payments, if approved by Congress. In return, Litton would have to cooperate with an audit effort to confirm the current alleged financial deficit and would

have to agree to a cap. Litton's President agreed, although he expressed some reservations about the extent of an audit.

In anticipation of another counter-proposal from the corporation, the Navy representatives devised a flexible plan which provided possible solutions to a multitude of arguments. In order to promote continued performance, it was their intention to forward a letter to the parent corporation calling attention to the agreement signed in June 1971 pledging Litton Industries' guarantee for the financial support of Ingalls and its contracts; simultaneously, the Navy would seek Congressional approval for a \$75 million advance payment. This money would provide long term aid while a loan could suffice for interim financing.

In the event that Litton chose to stop work, the Navy had available several options. The Justice Department could be called upon to initiate court action necessary to enforce performance. The company would be challenged on the legal requirement to honor the guarantee given to the government, assuring full and faithful performance of the shipbuilding subsidiary [2]. In order to avoid lengthy litigation, the Navy might decide to participate with Litton in sharing the fiscal burden of the shipyard. The Navy estimated that it could offer approximately \$30 million. This amount, consisting of \$6 million of escalation payments billed but not yet paid, was due to normal delays in publishing the indices upon which the payments were based. The remaining \$24 million would be taken from performance retainages earned but

not usually paid until delivery of the ships. These payments would be predicated upon an audit and cap agreement.

Due to the impracticality of any alternative offered in a Default Termination situation, the Navy considered it unwise to pursue any actions which might induce the contractor to halt production. Any default option considered would result in the same outcome--Ingalls would build the ships only if it desired to do so [3]. The Navy could assume management of the yard with the intention of hiring an outside contractor to complete the ships. However, the government could face opposition from the state of Mississippi as the legal owner of the land on which the shipyard is located.

The two factions met again in late January to discuss particular aspects of the problem. Attendees included Deputy Secretary of Defense Clements and Secretary of the Navy Warner. The contractor indicated that he had invested nearly \$31 million in the program since the payments ceased in October. All commercial contracts had been completed; thus, the yard was totally dependent upon Navy support.

Litton's prime appeal centered on improving the "climate" in which a settlement could occur and a request for interim assistance with the cash flow dilemma prior to the corporation's discussions with its lending consortium. Mr. O'Green indicated that outstanding notes payable and long term liabilities due totaled \$260 million; he also provided a letter from Wells-Fargo, which was the lead bank in the 34 member lending group, forwarning the company about possible restrictions being placed on any further shipyard expenditures as

a condition to the 1974 Credit Agreement [4].

It was during this meeting that one of the Navy's strong bargaining points may have been compromised. When Litton's President objected to the need for a cap on the claim as a prerequisite for relief, Mr. Clements replied that Litton could be given six months to decide on a cap figure. They would then have had 18 months to make such a calculation and should stand ready to negotiate [5]. Subsequent discussions revealed the Navy's perception that this capitulation had weakened their leverage on bringing the contractor to a bargaining position. Litton had, in the meantime, partially fulfilled the requirement to permit the DCAA to conduct an audit.

A copy of the corporate Cash Plan covering the period August 1973 to July 1975 was provided to the audit agency. This report confirmed the \$31.1 million negative cash flow on the LHA; furthermore, the schedule showed sales of Litton's commercial paper dropping from \$73 million in October '72 to \$2 million in July '73. The report attributed the decline to adverse publicity about the Navy contracts. An overall summary of FY 74's cash plan revealed a \$57.1 million shortfall. In computing this figure, the company assigned \$100 million of unused credit lines as backup for commercial paper or foreign overdrafts. This represented a 100% safeguard; the same requirement was not shown in the FY 73 plan although the company stated that it had existed.

While the SEC regulations do require such disclosures, they certainly do not demand the total backup. If Litton had utilized the same policy as in previous years, there would have been a \$42.9 million surplus vice the shortfall [6]. It was imaginative accounting procedures such as these and Litton's refusal to divulge data to support the cash flow projections which prompted the DCAA to defer any comments concerning the ultimate impact of the unsettled claims.

On 2 February 1974, the first progress payment on the LHA contract was presented to Litton. The previous overpayment, including interest, had been recouped. Physical progress on LHA production was estimated at 58%.

Throughout the month of February, negotiations continued in an attempt to arrive at a contract modification which would provide a mutually approved Reset Proposal including a cap. The Navy's offer remained at \$200 million while Litton's tended toward their \$376 million claim figure. In the ongoing discussions, Litton was offered \$20 million+ for the settlement of the East bank claims (excluding SUBSAFE) to provide them with interim cash relief. The shipbuilder felt obliged to refuse this settlement. The Navy also suggested, in return for executing the contract modification, payment of previously discussed money from the LHA contract [7]. Litton was receptive to this idea, but again balked at compromise on a cap.

Ironically, the final draft of the Navy version of the modification did not include a provision for the claim

ceiling. In retrospect, it seems perplexing that the Navy could have been so insistent on such an agreement over a period of several months deliberations and then have chosen to discard it. Certainly the contractor had not gained an advantageous position; why had the Navy intensely bargained for this condition and not pursued it to a final conclusion? An unsigned document dated 27 February stated "that the decision to forego a cap at this time emanated at a higher Pentagon level" i.e. above NAVMAT or NAVSHIPS.

Litton had agreed that the considerations offered in the modification (i.e. more current escalation payments and a revised progress payment system) were sufficient to satisfy their cash shortages. If they found it necessary to seek additional extraordinary funding in the future, they would then negotiate for a cap. Mr. O'Green had previously given oral acceptance of such a change, but the final version was not officially accepted.

Mr. Thornton, Chairman of the Board, met with Mr. Clements and agreed to a cap of \$150-200 million in exchange for approximately \$50 million of relief. Previously he had rejected this cap as inequitable to Litton. The Navy had since refined its estimate to slightly more than \$100 million for a reasonable cap amount [8]. The frustrating factor in this stalemate was that Litton was unwilling to accept the normal means of payments in such situations. The company had been offered advance payments on the contract (in reality, a loan) or provisional payments on the claim. For the latter, there

was a requirement to submit evidence which would support the claim. To this plea, Litton had replied, "What do you want us to do? Build ships or prepare claims?" [9] Consequently, their constant requests for extraordinary means of relief resulted in the circuitous and nearly fruitless talks taking place during this period.

The DD-963 program, which had been almost overshadowed by the hardships of the LHA, suddenly gained public attention. Litton informed the Navy that the costs for the 30 ships had risen by \$350 million and might climb as much as \$485 million above that [10]. The Navy approved a \$200 million increase in billing base due to increased costs of supplier's materials. An increase of the full \$350 million would raise the price to the contract ceiling price. At the same time, the analysis of the Reset Proposal presently under consideration hinted that the costs might be in excess of the reported \$350 million.

Representative Les Aspin immediately attacked the Navy and predicted that it would "totally cave-in to Litton's demands" during the reset negotiations. Despite the fact that the Proposal was intended to allow for finalization of costs, he urged that the Navy "not give them an extra dime". One could applaud Mr. Aspin for the zealous execution of his oversight responsibility; however, his resounding attacks on the Navy and Litton Industries did little to preserve the failing business relationship between the two.

The exchange of proposals and counter-proposals wore on into mid-year. Litton was approaching the end of its fiscal

year in a tenuous situation. The corporation had no tangible evidence of the Navy's intention to fund their short-term cash shortages; Mr. Thornton voiced the redundant warning that the corporation was having great difficulty persuading the banks to renew their line of credit. He added that the company had sold or closed 16 subsidiary companies in the last 15 months to maintain required ratios [11].

1. Specific Provisions

Litton presented what appeared to be a final effort prior to the close of their fiscal year and its attendant credit negotiations. On 24 May, Mr. Marandino confronted the government with an overture to settle all outstanding issues. He alluded that the corporate leaders had retreated and he had been given the authority to effect a settlement. Specifically, he related the belief that the most reasonable approach was on the basis of a total yard/total cash flow/total issue solution. His attitude made it apparent that the company had revised its position and might now be ready to deal with the Navy.

The President of Ingalls suggested that an out-of-court decision take place as soon as possible; he left the impression that the corporation might accept lower payments than had been previously sought. The AE, SSN 680 and Project X claims were in various stages of hearings before the ASBCA. The Navy's consideration of an equitable value of each would depend upon an evaluation of the potential ASBCA outcome and the amount awarded by that body or by the next level of

appeal, the Court of Claims. The company advised that they would now accept a \$250 million cap. When questioned as to the support for that figure, they advised that it had arisen during conversations with "the Navy", but they stood ready to bargain for a lesser amount [12].

The escalation and retention payments sought in previous modifications were still desired; two new items to be considered included a change to the method of computing progress payments and a request for deferral of \$2.1 million owed as interest on the cost payments received during the 21 day negotiation period.

The contractor also resurrected the issue of MPD costs. The tentative 963 Reset Proposal had acknowledged that the contractor accepted this \$90 million as out of pocket costs; nevertheless, he now petitioned to have this amount added to the contract costs for purposes of increasing progress payments. The government had consistently denied any liability for these costs. Litton was again advised that full disclosure of the source of the expenses was necessary prior to any consideration by the Navy.

Litton's initiative in creating a renewed atmosphere for deliberations was cause for hope among Navy officials. Although the two parties had previously arrived at this state of imminent cooperation only to see their ambitions dissipate, it was felt that neither could afford to invest anything less than a totally dedicated effort. To this end, both parties moved to prepare their bargaining positions.

As an integral part of developing the Navy's offer, Admiral Kidd realized the necessity of reaffirming the extent of Litton's financial plight. With this justification, he would be able to rally support for the Navy's choice to provide additional assistance to the shipbuilder. In response to his inquiry concerning the previously reported sale of 16 companies, Senior Vice President Joseph Casey provided a memorandum which listed just two specific sales, Rust and Stouffer for \$123 million and "other liquidations" for \$27 million [13]. A following letter provided the entire list of liquidations; it was stated that some occurred "to avoid additional investment". It seemed that once again Litton chose to interpret their normal business transactions to be a direct result of the claims problem rather than normal management choices.

The stockholder's letter published at the end of the year referred to these sales as a sound management decision. The closures and readjustments, most of which occurred in the Business Systems and Equipment group, were reportedly a result of the change in demand from electromechanical devices to the fully electronic successors. The phaseout of some segments were "a continuous and deliberate process" designed to take advantage of more profitable lines [14].

Litton continued to voice concern that the claims would have a direct impact on the deliberations of their lending banks. Admiral Kidd and Mr. Thornton engaged in almost daily conversations concerning the consequences of the

Navy's reluctance to provide cash without adequate consideration from Litton. The parties shared mutual worry about any restrictions on spending at the shipyard. It must be noted, that at this time, the two Navy contracts were in a cumulative positive cash flow status. The negative flow on the LHA was more than offset by the DD payments which were 105% of costs. The LHA escalation payments would expire in November 1974 and it was expected that the positive flow would begin to decrease at that time.

On 17 July, the corporation concluded a \$250 million revolving credit term loan with 15 participating domestic banks. A brief analysis of the credit agreement covenants does not reflect the grim fiscal strain that Litton had labored so hard to project. The previous agreement contained an allowable ratio of Funded Debt to Consolidated Adjusted Net Tangible Assets (CANTA). Litton had experienced difficulty in remaining below the 40% limit and, therefore, encountered borrowing difficulties. The newly signed agreement substituted a Liability to Net Worth ratio which was currently 1.85 to 1, but would become more restrictive in later years. The \$700 million minimum net worth requirement had not been a problem in the past. The covenants, which restricted acquisitions, dividend payments and treasury stock purchases, could inhibit the continuation of past growth policies; however, the Navy could benefit in that the funds could be utilized within the shipyard. In general, the commitment of fewer banks to provide more funding during

this era of tight credit would seem to indicate trust in the borrower's fiscal potential.

By mid-July 1974, the two parties had been engaged in concentrated negotiations for the past nine months with little success. Recently, the Navy had advanced to the contractor a sum of \$5.6 million to bring escalation payments up to date. No other payments had been authorized. The government had expected Litton to commence submission of 56 constructive change order packages which would substantiate the \$376 million REA, but none had been forthcoming. Without these documents, the chance for a bargaining settlement on the LHA claim was non-existent. On 25 July, Ingalls informed NAVSEA that they intended to pursue the appeal before the ASBCA rather than rely solely upon attempts at a bilateral resolution. One can only speculate that they must have considered the chance for success in that endeavor to be more favorable than attempting to justify the claims as would have been necessary for a negotiated unanimity.

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2. Litton Systems, Inc., Novation and Change of Name Agreement, 30 July 1971.
3. Renfro, E. E., RADM, USN, Deputy Commander for Contracts, Naval Ship Systems Command, List of U. S. Navy Alternatives, Title: Obtaining LHA Contract Performance, 17 January 1974.
4. Kidd, Isaac, Jr., ADM, USN, Chief of Naval Material, Memorandum for the Record, Subject: Meeting with the DEPSECDEF on 22 January 1974 concerning Litton's Financial Problems, p. 6, 23 January 1974.

5. Ibid, p. 7.
6. Defense Contract Audit Agency, Report on Review of Fiscal Year 1974 Cash Plan Submitted Litton Industries, Inc., p. 7, 29 January 1974.
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8. Woodfin, K. L., RADM, USN, Contracting Officer, Naval Ship Systems Command, Memorandum for the Secretary of the Navy, Subject: Litton LHA Negotiations, undated (circa March 1974).
9. Phelan, John J., Office of General Counsel, Memorandum for the Secretary of the Navy, Subject: Litton FHA Negotiations, 12 March 1974.
10. "Litton Confirms \$350 Million Overrun," Washington Star-News, p. C-22, 24 March 1974.
11. Kidd, Isaac, Jr., ADM, USN, Chief of Naval Material, Memorandum for the Chief of Naval Operations, Subject: Chairman of the Board Litton Industries, Mr. Thornton, Visit to NavMat, Thursday, 9 May 1974, undated.
12. Renfro, E. E., RADM, USN, Deputy Commander for Contracts, Naval Ship Systems Command, Memorandum for Commander, Naval Ship Systems Command, Subject: Potential Settlement of Litton/Ingalls Problem, 28 May 1974.
13. Casey, Joseph T., Senior Vice President, Litton Industries, Inc., Memorandum to Charles B. Thornton, Subject: Extraordinary Actions to Generate Cash, 31 May 1974.
14. Litton Industries, Inc., Annual Report for the Fiscal Year ended 31 July 1974, p. 4-5, 14 October 1974.

E. PLAN OF ACTION

Litton began FY 1975 in a rather tenuous manner. There had been no agreement reached on the DD-963 Reset Proposal; efforts to reach an accord on the LHA reset and the claims, in general, had again reached a deadlock. The business year just completed had resulted in a \$39.8 million net loss; the year-end position revealed a violation of the Liabilities/Net Worth ratio. As the losses on the shipbuilding program had not yet been recognized, the financial outlook appeared clouded. With their patience exhausted, Litton chose to re-instate the LHA appeal before the ASBCA.

It is important to realize that, despite the impressions presented by the corporate directors, Ingalls was not the only division of the company in difficulty, especially during the year then just completed.

In the early years of its operations, Litton displayed strong growth patterns. In its first four years, sales increased from \$3M to \$100M; 88% of that increase was due to acquisition of 17 existing companies. The following corporate sales increases also testify to Litton's success: '55-'57, 215%; '57-'59, 346%; '61-'63, 121%; '65-'67, 74%. After 1968, the trend became much diminished and quite erratic. The activity ranged from a 4% sales decline between 1971 and 1973 to an increase of 42% between 1973 and 1975. Ingalls' contribution to corporate sales since 1970 has varied between 9.2% in 1973 and 22.4% in 1975. These numbers should be viewed with caution, however, since Ingalls computed their

yearly sales based on percentage of completion of the contracts which had full value equal to the builder's estimated completion costs vice the actual contract amount. Nevertheless, over the past eight years Ingalls has accounted for an average of 16.5% of Litton's sales.

An example of the magnitude of difficulties in non-marine divisions would be the Business System and Equipment group in 1974. Two areas of development, business mini-computers and electronic point-of-sale retail terminals, were continually reported as requiring heavy investments in return for future earnings. Despite strong sales growth, the year-end profits were expected to be very restricted. In the six month report to the stockholders, the company indicated that Ralph O'Brien, then head of that division, and William Berry, head of the typewriter and office-copier branch, had been re-assigned as director and assistant director of the company's long-range planning office. The following year both names were absent from the list of officers. The office copier, mini-computer and typewriter branches were directed to report to the corporate president, Fred O'Green. Likewise, the leadership of the Specialty Paper, Printing & Forms and the Business Furnishings and Fixture divisions were placed under the supervision of more senior company officers. The FY 74 Annual Report revealed an annual sales increase of 14%, but a 31% decrease in operating profits for the Business System and Equipment group. The company recorded a \$60 million (after tax) write-off for costs associated with the changes which had taken place in that product line.

In addition to their internal difficulties, the corporation was in the grip of constricting external economic factors. The Material Index for NAVSHIPS Steel Vessel contracts had increased approximately 30% from the previous year's level. This index reflected the general price trend for general purpose and electrical machinery products and steel mill products. All of these items were needed for ship construction and had appreciably increased in price. The country was in the midst of a severe energy shortage, which increased delivery time for needed materials and influenced the skilled laborers to migrate to more lucrative energy-related construction industries.

Litton had informally notified the Navy that both programs could experience delays longer than those already recognized. It was expected that the last LHA and DD might be delivered 12 and 18 months later than planned. The Navy's worst case estimates computed that the LHA could require an additional nine million manhours resulting in a \$169 million loss to Litton; similar calculations for the DD program yielded a possible \$61 million loss due to an increase of six million manhours. This total loss figure included MPD costs [1].

The Ingalls management recognized the possibility of heavy losses on the LHA so they dedicated full manning to the DD construction and submarine repair with the LHA absorbing any labor shortfalls. The LHA's lagging progress would be difficult to recover; the DD payments remained at 105% of

costs. It was in Litton's best interest to ensure that progress on that ship did not falter. Ingalls had made several previous attempts to have the Navy sanction their decision on manpower assignments. To avoid the possibility that such an agreement could jeopardize future claim negotiations, the Navy refrained from any concurrence with their actions. As long as the shipbuilder made any measurable progress on the LHA, there was no basis for a default action. The minimal progress indicated that the delivery schedule, which had been established in the C.O. Decision, would probably not be met.

Meanwhile, discussions continued within the Navy administration in an attempt to ascertain Litton's true financial needs. In early September 1974, the two sides reached a joint resolution on the AE claim for which the Navy provided an \$18 million payment. Negotiating personnel had hoped that in the process of liquidating that claim, they might be able to settle all of the East bank claims. The SSN-680 and Project X claims presented more difficulty. The Justice Department was investigating the circumstances surrounding the submarine claim for the possibility of fraudulent supporting data. The SUBSAFE claim presented a precedent within the claim area for its alleged disruption or "ripple effect" on the other contracts. The Navy stood ready to defend this claim as vigorously as necessary to effect an equitable settlement.

The hopes and anticipation for success, normally inherent in the beginning of a new year, were not evident to those

involved in the Litton claims endeavor. In a letter to the NAVSEA Contracting Officer, Joseph Casey, a corporate financial Vice President, charged that "an inability or lack of determination on the part of the government to settle legitimate claims and changes, has levied a direct and severe penalty on Litton and its shareholders" [2]. He reflected that Litton had been hampered in its efforts to take advantage of profitable opportunities due to the great amounts of money they had to provide to Ingalls. He admitted a portion of this investment was to be expected in the shipbuilding industry, but the majority was attributable to the Navy's refusal to act on changes and claims. Not surprisingly, he neglected to find any weaknesses in the business acumen displayed by the corporation.

Supporting data provided on 16 January 1975 indicated that LHA costs exceeded payments by \$27.1 million; a projection to FY 78 indicated the deficit could climb to \$189.4 million. The DD, however, displayed a positive cash position of \$57 million. The figures projected that the cumulative flow would become negative sometime during the second quarter of FY 76 (November 1975-January 1976) [3].

Although there was little progress on the LHA claim itself, other matters were being pursued. On 17 January, the two parties reached mutual consent on the debate about interest payments for the original \$54.6 million overpayment. Previously, the Navy had withheld \$2.2 million from payments to cover the debt; it was finally decided to release the

money pending the outcome of the ASBCA hearing on the entire LHA issue.

During this same period, the DD-963 Reset Proposal, which had been resubmitted in late October, was the subject of intense bargaining. Although there were differences on labor and overhead rates and the amount of escalation to be recovered, the exchange of reasonable proposals hinted that a settlement was imminent.

On 28 March 1975, Vice Admiral Gooding (COMNAVSEA) forwarded to the Secretary of the Navy, a proposal of a new dimension. He suggested that mutual responsibility had been recognized and that Litton had conceded, in principle, to accept a fixed loss in return for a final solution to the long-standing dispute. His offering incorporated the use of PL 85-804⁴ to restructure the contract. Additional compromise would be required in the form of a release of claims, a firm delivery schedule, cash flow relief and a promise by Litton to retain the funds from the Navy contracts for use only in the shipyard (Fencing Agreement) [4]. In principle, this approach was equitable and presented an avenue for mutual appeasement.

Admiral Kidd viewed it from a more pragmatic aspect. It was his opinion that the implementation of the law would relieve the contractor from the responsibility of providing

⁴This law allows the settlement of contracts through extraordinary means when in the interest of national defense. For further explanation see page 96.

specific data necessary to substantiate the REA. Litton's past promises to "prove" their position had not been fulfilled. The use of extraordinary alternatives was not warranted until the validity of the claim had been proven. Litton had previously guaranteed performance of the shipyard; to resort to the use of the Public Law would have relieved them of that responsibility. In the course of preparing its proposal, the Navy had determined that the last LHA and DD would probably not be delivered until June 1978 and March 1980 respectively. Admiral Kidd realized the need for an immediate solution which would secure the availability of the ships prior to those dates. Nevertheless, he abstained from forwarding the proposal to SECNAV. It was his opinion that conditions were inappropriate for such an alternative.

Navy discussions considered that a "fixed loss" contract was unlikely to motivate the contractor to increase his production rate on the LHA. Repairing submarines and building the DD-963 provided the funds and those would continue to be the reasonable projects on which he would concentrate his efforts. Litton had been unable, thus far, to provide a realistic estimate of final costs for either of the contracts; therefore, deriving a loss figure for Litton would not provide any assurance of the Navy's final liability. It was agreed, that any contract change pursued must include firm delivery dates with more severe late-delivery penalties than were presently in effect.

In the fall of 1974, the ASBCA had directed Litton to quantify the specific amounts included in their LHA appeal. Litton's reply, which was finally presented in April 1975, confirmed the Navy's concern for the steadily rising costs. Litton submitted a revised claim of \$504.8 million. This new figure was reported to have resulted from delays occurring since 1972 and the '73-'74 rate of inflation of labor and material prices. The company hastened to point out that this amount should not be compared to the previous estimate which lacked adequate provisions for the delay and inflation. The higher figure supposedly included inflation to date and projected to the 1979 completion date [5]. The total claim consisted of three categories: Changes \$86.1 million, Delay \$337.1 million and Disruption \$81.6 million. Included with the revised REA was an extended delivery schedule which would result in cumulative delays from 37 months for LHA-1 up to 65 months for LHA-5.

The Navy and the corporation continued simultaneous discussions on the LHA dispute and the DD Reset Proposal differences. Both were in general agreement on the final prices for the destroyers, but there was substantial disagreement over the Navy's desire to be released from liability for any claim causes prior to 28 April 1974 (the cutoff date on Litton's price proposal). The Navy held the position that a price submitted at that time should have reflected all known reasons for a cost adjustment prior to that date. Litton hesitated to make that concession since it had not been

included on the original contract. Additionally, the corporation stated that their offer had not been prepared with the claims release in mind. Such a statement would indicate that they intended to seek future price adjustments; the company insisted there was no business risk for the Navy in any necessary future price hikes since they (Litton) would have to show entitlement before seeking such an adjustment from the government.

As the LHA bargaining progressed, the Navy recognized a need to ensure that any funds provided to Ingalls would be used only in the shipyard. The corporation had continually presented its appeals based on the hardships inflicted on the entire conglomerate structure by the troubled shipbuilding contracts. One can surmise that Litton realized that they would eventually have to assume a portion of the loss on the LHA contract. It would have been to their advantage to immediately utilize available funds on more fertile projects in an attempt to offset any future shipbuilding losses. The Navy's primary interest was expediting the delivery of its ships. To ensure that any funds provided in the future would be applied to the ship contracts, the Navy Comptroller's Office formulated a tentative "fencing" agreement.

This proposal called for Litton to establish a special bank account into which all Navy payments to Ingalls would have been deposited. Over the years, the parent had made advances to the shipbuilding subsidiary to support its operations; Ingalls repaid the balance as cash receipts allowed.

The balance in this account amounted to \$159 million. It was decided that the then present balance would constitute the minimum to be maintained. While the cumulative cash flow to Ingalls remained positive, there should have been no need for additional advances from Litton. When the flow became negative, Ingalls could have utilized any excess funds in the "fenced" bank account prior to seeking corporate advances. The excess payments provided by the Navy would have been deposited in the bank account rather than having been used in other divisions of the conglomerate [6]. This spending restriction required that any large payment, such as a claim settlement, could have been used only in the shipyard. Placing a lower limit on the advances account prevented the company from depleting that fund when payments were placed in the special bank account. While this arrangement provided that Navy funds would have supported only Navy programs, it was necessary to consider that the Navy would have been controlling how Litton spent its cash. This "overmanagement" by the government might have warranted future criticism from the contractor for inflicting undue losses upon the corporate entity.

Following several weeks consideration of the possible repercussions of interfering with Litton's business decisions, the Assistant Secretary of the Navy (FM) informed Litton in mid-June 1975 that the "fencing" agreement could be mutually discarded. In return, the Navy sought and received reassurances that there was no bank-imposed restriction on use

of available credit to support the marine construction programs.

Even though the funding arrangement was not implemented, Litton should have been able to sense a renewed urgency on the part of the Navy. A settlement on the DD Reset appeared more likely than did an LHA agreement; the Navy indicated to the corporation that, if necessary, a Contracting Officer decision would be invoked on the DD contract also.

In an attempt to avoid that choice with its lingering uncertainty, Mr. Archie Dunn, the Director of Contracts from Ingalls, met with personnel from NAVMAT on 1 July 1975. Mr. Dunn informed them that Litton was willing to sign the DD Reset Proposal including a claim release, as long as it applied only to the destroyers; no claim would have been lodged against the DD contract, but could have been included with the LHA claim as impact. The two parties reached an accord in late July when the Reset was finally signed, culminating many months of laborious negotiations. The ceiling price was set at \$2.201 billion which included \$62 million for authorized changes [7].

It was the hope of the Navy that the success with the DD talks might have influenced both parties to persist in the efforts to resolve the LHA contractual dispute. The LHA trial before the ASBCA would not have begun until mid-1976; past experience indicated that a final judgment could not be expected from that body for three or four years. A negotiated settlement appeared to be the only viable alternative.

In mid-April, Admiral F. H. Michaelis had assumed duties as CNM. Less than two weeks later, Ned Marandino was replaced by Leonard Erb as President of Ingalls. It is this author's impression that these personnel changes signalled a perceptible improvement in the business relationship between the two factions. It is not difficult to realize the frustration which must have preyed upon the two hard-working officials who were relieved.

As part of the concentrated effort toward a resolution, there developed within the Navy two general attitudes as to how best appease the contractor. The Navy Secretariat was inclined toward providing a single large payment through the use of PL 85-804 or a reformed contract; CNM and CNSea proposed smaller continual payments. Both options had their advantages; the latter, however, would be less likely to draw Congressional opposition (most of the smaller payments could be made without seeking Congressional approval) and it would prevent any misunderstandings about cost allocation, which might develop with an FP and cost-type contract side by side in the same yard. Both sides concurred on the obvious need to take whatever measures necessary to prevent a work stoppage and on the benefits inherent in carefully awarding new contracts for which Ingalls might have been eligible [8].

In an attempt to facilitate the Navy's deliberations, Ingalls submitted portions of its FY 76-1 Operating Plan. The company indicated that the significant increases in negative cash flow could be attributed to the enhanced level of

manning on the LHA which was necessary to condense the present schedule. The yard's employment level, then at 23,000+ had increased by 3,300 in the prior two months with 78% of the new hires representing critical trades.

On 31 July 1975, the corporate advances made to Ingalls had a balance of \$134 million. The cash flow deficits projected for the subsequent years to FY 80 equaled \$245 million creating a need for Litton to increase the advances to \$379 million. Their projections revealed that the combined cash flow of LHA and DD would finally become negative in late September, 1975. The gravity of this financial impact prompted renewed considerations for any possible means of relief.

The likely source of funds appeared to be the DD program. As had been previously mentioned, the progress payments were limited to 105% of booked costs. This resulted in an accumulation of earned funds which would have been paid as progress slowed during the later portions of the contract. The escalation retentions amounted to \$169 million at the end of August 1975. A year later, only \$60 million remained in the account. Declining progress before that time resulted in the remainder being used to maintain the 105% of cost payments. This money could have been released with Congressional approval to raise the payment ceiling above the 105% limitation. Congressional climate was such that arousing any false suspicions then could have hindered future lump sum settlement attempts.

Funds controlled within the Navy might have also been available. There was \$4 million earmarked for long-lead procurement of materials to support six DD which were to be built for the Iranian Navy. This program, which was later reduced to four, was on a cost reimbursable basis and would have followed the 30th U.S. destroyer. The 963 contract could have been modified for early release of performance retentions equal to \$1.9 million per ship. These funds would normally have been available at the time of delivery of each ship.

The final alternative would have required an out-of-court settlement on a portion of the LHA appeal. As part of the claim, Litton had challenged the denominator used in a percentage of completion fraction. The contractor stated that the use of an increased material cost figure vice the lower original contract figure had resulted in a lower percentage completion and had been contrary to the intent of the original contract. This equated to a progress underpayment of about \$40 million; this claim, known as the SACAM⁵ issue, carried with it interest then worth \$12 million [9]. In return for any of these funds, Litton had to withdraw from the ASBCA the major portion of the LHA claim.

In early November, Mr. Gary Penisten, the Assistant Secretary of the Navy for Financial Management, enlisted the assistance of an outside accounting firm, Haskin & Sells, to

⁵This portion of the LHA claim referred to a dispute based on a clause in the Navy Ship Acquisition Manual (SACAM).

investigate the financial status of the corporation. This firm confirmed the cash shortfalls which the yard had presented in the Operating Plan--\$72 million in FY 76 and \$136 million in FY 77. The corporation would have required an estimated \$215 million of new financing in FY 77; the continued adverse relationship with the Navy could not have kept the bankers in a very understanding mood. The accountants estimated that the losses on the LHA could climb as high as \$350 million.

The Navy Secretary realized that an immediate plan of affirmative effort was necessary if the Navy wished to avoid the possibility of a work interruption. He suggested to Mr. O'Green that they establish a Plan of Action which could result in long-awaited financial assistance. This formal resolution would have addressed both short (less than a year) and longer-term alternatives.

On 2 December, the Plan of Action was submitted to Litton for their formal approval. The short-term solutions consisted of certain earned, but not payable, sources of cash (i.e. escalation, retentions, etc.) which could have precluded the need for additional financing from corporate headquarters. The parties were to engage in negotiations necessary to resolve the early portion (\$246 million) of the claim resulting from the six month delay recognized by the C.O. Decision in February 1973.

The Navy asked that Litton withdraw the LHA appeal from the ASBCA and that discussions begin immediately. If the

contractor had been able to provide data to support the merit of the LHA claim components, the Navy would have had adequate justification to commence paying off the claim.

During past endeavors of a similar nature, the time limits, allowed for execution of the various stages of a solution had seemed too confining. As the intended completion dates approached without significant gains having been realized, the participants became less cooperative than at the onset of deliberations. The Navy attempted to prevent a similar re-occurrence with the Plan of Action. The deadline for short term efforts extended to February 1976 while June 1977 was the target for the long-term undertaking.

Also included in the offer was a statement which ensured each participant of the other's good faith. In the event that cash was not forthcoming in amounts sufficient to support a satisfactory production schedule or if provisional payments did not equal \$150 million (number chosen by Litton) by June 1977, Litton could have reinstated the appeal before the ASBCA. The Navy could have utilized all authority within the contract and provisions of law to force performance if Litton had chosen to discontinue working on any of the contracts.

During the period that the Navy was awaiting Litton's final approval of the Plan, there was concern whether the provisions had been sufficient to solve the fiscal dilemma. Litton's bankers had pressed for some assurance that a positive or zero cash flow would result from the deliberations. The Navy was not able to provide such a pronouncement.

Additionally, the success of this action hinged on the corporation's ability to properly substantiate the allegations in the claim. If they were unable to do so in a timely manner, the entire effort would have collapsed in failure. The sources of short-term assistance were temporary and not expected to be sufficient if Litton's costs continued to spiral beyond available estimates.

On 7 January 1976, the Plan of Action was officially enacted. In so doing, Litton agreed to immediately begin submission of the supporting documentation for the approximately 50 claim elements. The final submission was scheduled for 1 December 1976. The two parties petitioned the ASBCA for dismissal of the LHA appeal with the exception of the SACAM issue. This request was granted two days later. The Navy and Litton were prepared to move forward on a concentrated and well-planned mission in search of a final resolution of their mutually perplexing dispute.

1. Naval Material Command, Financial Aspects-Talking Notes-Litton, August 1974.
2. Casey, Joseph T., Senior Vice President, Litton Industries, Inc., Letter to S. C. Kzirian, Code 0225, Naval Sea Systems Command, Subject: Payment of Ingalls Shipbuilding Cash Requirements, 6 January 1975.
3. Dunn, Archie J., Vice President, Administration, Ingalls Shipbuilding Division, Letter to S. C. Kzirian, Naval Sea Systems Command, Subject: Submission of Contractor Financial Data, 16 January 1975.
4. Gooding, R. C., VADM, USN, Commander, Naval Sea Systems Command, Memorandum for the Secretary of the Navy, Subject: Ingalls/Litton LHA Contract Adjustment, 28 March 1975.

5. Litton Industries, Inc., News Release, Subject: Increase of Claim to \$504.8 Million, 21 April 1975.
6. Burchfield, F. J., Director of Banking and Contract Financing, Office of Comptroller, Department of the Navy, Memorandum for the Assistant Secretary of the Navy (FM), Subject: Litton Fencing Agreement, 5 June 1975.
7. Litton Industries, Inc., Annual Report for the Fiscal Year ended 31 July 1975, p. 4, 14 October 1975.
8. Kidd, Isaac, Jr., ADM, USN, Chief of Naval Material, Memorandum to NavMat-02, Subject: Litton, 18 August 1975.
9. McBride, Gerald, Assistant Deputy Commander for Contracts (SEA-02B), Memorandum to Assistant Deputy Chief of Naval Material (P&P)(MAT-02B), Subject: Draft Paper on Ingalls Shipbuilding Cash Flow dated 16 September 1975; comments concerning, 22 September 1975.

F. PUBLIC LAW 85-804 OFFER BY DEPUTY SECRETARY OF DEFENSE
W. P. CLEMENTS

On the same day the ASBCA ceased processing the claim, Litton received a reply to their appeal for adjustments to the cancellation refund of \$109.7 million. When the four LHAs were cancelled, Litton claimed that this figure had been derived relative to the ceiling price and that they were entitled to approximately \$20 million for an adjustment between the target and ceiling prices. The Navy, however, replied that this refund was a maximum amount and that it was coordinated to the target price. Litton's claim was based on their belief that a mutual mistake had been made in failing to specifically denote in the contract which price would serve as a reference point.

The National Contract Adjustment Board (NCAB), while conducting hearings on this appeal, presented internal memoranda from Litton which indicated that the corporation's negotiators had known that the target price would be used. These documents revealed that Litton was displeased with the use of that figure vice the ceiling price, but made no further effort to have it changed. Based on this evidence, the NCAB upheld its previous denial of Litton's request for adjustment [1].

Despite the setback on this aspect of the claim, the company enjoyed temporary relief when the Navy released approximately \$50 million as payment of the principal sum of the SACAM claim. This belated progress payment provided sufficient

funding to return the two contracts to a cumulative positive cash flow condition which could have lasted until the fall of 1976.

In late March, there appeared the first signs that this renewed effort was proceeding toward positive results. Litton had submitted the initial documentation to the Claims Team, headed by Captain Ron Jones from NAVMAT, and was informed that provisional payments could be forthcoming in early April. Although corporate officials believed that this package should have yielded a \$50 million payment, the NAVMAT Claims Board recommended that only a \$20 million provisional ceiling price increase be approved.

In the meantime, the Department of Defense moved to assist the Navy with elimination of the \$1.7 billion claim backlog. It was their intention to resolve this dispute between the Navy and several of the nation's largest shipbuilders--Electric Boat Division of General Dynamics, Tenneco's Newport News Shipbuilding & Drydock Company and Litton/Ingalls. Following a brief by CNM on 24 March, Deputy Secretary of Defense William P. Clements decided to pursue a comprehensive settlement utilizing PL 85-804.

Secretary Clements felt that the claims would have to be liquidated if the Navy hoped to continue competitive contracting with its private shipbuilders. The existing process of settlement had proven to be costly, time consuming, and in some cases, inequitable to the contractors. Overall it was grossly ineffective.

In recognition of the flexibility required to cope with the conditions which arise in the execution of multi-billion dollar defense programs, Congress had previously instituted PL 85-804. This law allowed the amending and modifying of contracts through extraordinary means in the interest of national defense. It would allow a circumvention of the intricate and often confusing contracting procedures which had contributed to the delayed resolution of the dilemma. It required that Congress be notified of its impending use and that a 60 day waiting period elapse prior to its execution.

On 30 April 1976, Mr. Clements informed the Chairmen of the House and Senate Armed Services Committees of his intention to utilize this available means of relief. He established 10 June as the date by which he expected to have reached an agreement with the three large shipyards and National Steel and Shipbuilding. During this and subsequent communications with members of Congress, he elaborated on the specific reason for his decision to invoke the statute.

1. Basis for the Offer

The Secretary pointed out that of ten claims taken before the ASBCA since 1969, it had taken five or more years from the date of the claim to reach a decision. Of the 48 claims which had been negotiated by the Navy since 1969, half had been settled in less than two years; the remainder required two to four years for an agreement [2]. The complexity and magnitude of the present claims were such that little improvement of these settlement times could be

expected. Business relationships between the Navy and these shipbuilders had deteriorated to an intolerable level.

The main thrust of his effort pointed to a revision of the method of escalation payments. With the clause in effect at that time, the contractor would not have been paid after the contract delivery date or above the target cost. In the case of the LHA, Litton would have been forced to work for almost five years without additional escalation compensation. The new clause offered by Mr. Clements would have frozen the escalation index at the contract delivery date level, but would have continued to provide payments until the actual delivery date or until the ceiling price was reached. This revised payment plan would have gained Litton about \$219 million for the LHA and \$112 million for the DD-963 [3].

During the period these negotiations were taking place, the ASBCA ordered the Navy to pay Ingalls \$17.3 million as a result of the decision on the SSN-680 claim. The circumstances surrounding the legality of this claim were still under investigation by the Justice Department. Consequently, the Navy withheld the payment. However, the government did provide a \$16 million increase to the LHA contract as a provisional payment on the delay portion of the LHA claim. Since the contractor's weekly costs exceeded his payments by approximately \$1.3 million, the total positive cash flow was slowly being eroded. It was expected that the \$16 million could extend the positive flow until August 1976.

In early June, Litton's unsettled claims totaled \$822 million (\$505M-LHA, \$108M-SUBSAFE, \$36M-SSN 680, \$20M-SACAM interest, \$20M-cancellation ceiling, \$133M-MPD). In return for the revision to the escalation clause, it was expected that the shipbuilders would withdraw the majority of their remaining claims and grant the Navy a release from future claims for any events prior to the day of the settlement.

On 10 June 1976, Mr. Clements notified the leaders of the House and Senate that his group had been unsuccessful in reaching an agreement with two of the contractors-Litton and Newport News. Since his original intention had been to effect an overall resolution to the problem, he withdrew from the Armed Services Committees the notification to use the Public Law option. The attempt at mutual understanding had been a failure. He did request that he be allowed to reinstate this petition in the event that future negotiations warranted it. He assured the Congress that the Navy would move expeditiously to resolve the claims through normal channels.

Litton had long agreed that the contract should be restructured under the authority of PL 85-804. However, they did not feel that the Secretary's offer reflected an equitable value for their claims. If the company had accepted the \$311 million in return for dismissal of the present and future claims, it would have had to absorb at least the \$511 million difference which then existed. With four LHAs and more than 26 DDs yet to deliver, it is likely that the shipbuilder anticipated costs to rise above those reflected in

his claims. Navy officials felt that Litton may have rejected the original offer in hopes that the Navy would have responded with one providing additional compensation.

Litton's rejection raised new fears of an LHA work stoppage. In mid-June the contractor was receiving about 30¢ in payment for each dollar of costs incurred on those ships. The cumulative cash flow would have become negative within the next two months although the DD contract would have continued to provide cash. After reviewing the alternatives, the Navy decided that continued negotiations as outlined in the Plan of Action provided the best opportunity for a compromise.

On 21 June, Ingalls Vice President Archie Dunn forwarded to Assistant Navy Secretary Penisten the 77-1 Ingalls Cash Plan which highlighted an increase of the LHA claim to \$701.7 million (\$101.7M hard-core changes and \$600M delay and disruption). This increase was attributed to approximately \$30 million for new hard-core changes and \$200 million for impact of the LHA upon the DD progress. This plan noted that the LHA suffered from a \$65 million cash deficiency which would have increased to \$407 million by FY 81. The DD, meanwhile, was expected to have a \$40.6 million final negative flow. Armed with this latest fiscal outlook, the Navy Secretariat, NAVMAT and NAVSEA began immediate consideration of possible means of expediting the claims processing for provisional payments.

Litton's financial year drew to a close with the company in a seemingly tenuous situation. The attempt at

settlement had faltered; the shipbuilding division's plan warned of even larger losses than had been previously predicted. Possibly even more important was the "unsolicited" attention the corporation had received. Although Secretary Clements insisted that his proposed settlement had not been prompted by the fiscal plight of any of the yards, Litton's stockholders must have held some doubts about the financial stability of their investment. Corporate leaders were faced with calming their fears while continuing intense, but discreet, appeals for government relief.

An analysis and interviews conducted for the NEW YORK TIMES inferred that Litton's condition was not as serious as had been projected to the Navy. Spokesmen insisted that the company was in no difficulty and that the shipyard had earned a nominal profit. At that time, the only contract which had earned any "profit" was the DD and it had been reported to be facing an ultimate loss. The interpretation of shipyard profit was questionable. Nevertheless, Mr. O'Green told a reporter, "We are healthy and strong and are generating cash. We have never said that we would be unable to fulfill the (assault ship) contract"[4].

1. Cruden, Joseph C., Acting Chairman, NCAB (Navy Contracts Adjustment Board), Memorandum for the Assistant Secretary of the Navy (Installations and Logistics), Subject: NCAB Decision Upon Rehearing Litton's Request for Correction of an Alleged Mistake in the LHA Contract, 9 January 1976.
2. Clements, William P., Deputy Secretary of Defense, Letter to Honorable John C. Stennis, Chairman, Committee on Armed Services, U.S. Senate, 11 May 1976.

3. Office of the Assistant Secretary of the Navy (Manpower Reserve Affairs & Logistics), Litton Claims Study, p. 78, 9 December 1977.
4. "Business Trends--Litton's Claims: High Stakes Poker," New York Times, Section C, 25 June 1976.

G. NOTICE OF INTENTION TO STOP WORK

The apparent sense of security displayed by Litton's President during his interview was short-lived. In a letter sent to Secretary Clements on 28 June 1976, the Board Chairman announced that work on the LHA contract would be discontinued on 1 August. Although he acknowledged the Navy's efforts to seek a settlement, he reflected that the company had already provided considerable support for the shipbuilding program; with no concrete evidence of a potential solution, this corporate backing could not continue. Litton estimated that they had already expended \$135 million to continue work on the LHA. This included \$43 million MPD and \$92 million in production costs. This expenditure was in addition to \$300 million long-term investment in the yard facilities. Mr. Thornton recalled that DOD had admitted to the failings of TPP after the contract had been awarded, but had refused to grant Litton any relief from the inequities of that system.

He offered two alternatives which could dissuade the company from its decision. One called for the reformation of the contract to a cost basis with Litton accepting a fixed loss. The other would have provided Litton with provisional payments during the lengthy settlement process. Although the contractor intended to halt construction as threatened, he assured the Secretary that the company remained anxious to negotiate on either of the two suggestions [1].

1. Litton's Justification

The official termination notice, which was sent to the Contracting Officer, cited several legal justifications

for the corporation's decision. The company charged that the Navy had violated the Anti-Deficiency Act. This statute prohibits the obligation of funds in excess to those appropriated. Litton's allegation stated that they would have been forced to finance the program for \$400 million above the present contract fund level. Since the government had not appropriated the money to reimburse them for these additional expenses, company officials contended that the Navy would have been in violation of the Act; recognizing that fact, Litton had felt it their duty to cease performance. The corporate interpretation of the law was correct; however, in the case of this ship's funding, which is provided from the much larger Ship Construction, Navy (SCN) general appropriation, the Navy argued against the applicability of the law.

Another point raised addressed the degree of influence the Navy had reportedly exerted upon the contractor. The concept of the TPP method depended upon Ingalls having had the freedom to design the ship to performance standards and then construct it. Litton charged that the Navy had disregarded the "hands off" method in favor of a "reengagement" which resulted in the Navy having had primary control over the design and production. The shipbuilder considered the Navy's transgression a blatant violation of the original contract.

Finally, the government was accused of having declined to honor the Plan of Action executed earlier in the year. It had been agreed that prompt payment would be made for any

decisions rendered by the ASBCA. When the board awarded payment on the SSN-680, the Navy refused to pay a large portion of the \$17.3 million judgment on the grounds that the Justice Department had not completed the verification of the validity of the original supporting data. This was alleged to be a breach of the mutually prepared plan [2].

The corporate spokesman insisted that the company would not have continued performance of the contract if any funding had been required from Litton. However, Mr. O'Green did offer to continue building the ships if full funding was provided until completion of work or resolution of the claims. These payments would have taken the form of a contract formation or steady provisional payments. In support of those alternatives, he indicated that Litton intended to submit their proposal for a contract conversion through the use of PL 85-804. The outlook for reaching an agreement via litigation appeared hopeless; the company would have no longer supported the Navy program. An extraordinary avenue to settlement was the remaining alternative.

The formal two-volume reformation document was submitted on 29 June. This request dealt with the correction of escalation inequities, correction of the "wrong type" of contract and its consequences, settlement of claims disputes and payment of short and long-term expenses until a final solution could be achieved. Also included was the suggestion of the contractor's willingness to assume a fixed loss on the contract.

The Navy had anticipated for some time that the contractor might decide to cease working on the LHA. The

possibility of such an action had been discussed during the ongoing discussions of the past few months. Faced with reality of additional serious delays of the LHA program, the government's reasonable choice to prevent the work stoppage lay with the courts. If Litton's threat had materialized, the Navy would have had little choice but to seek a temporary restraining order.

In the meantime, Navy officials busied themselves in an attempt to find an equitable solution which would have precluded the need for litigation. Ingalls 77-1 Operating Plan revealed a need for approximately \$62 million between August and December 1976. All claim packages were scheduled to have been submitted by December and it was expected that provisional or settlement payments could have begun then. The Navy was concerned with viable means of supporting the contracts until that time. An additional factor, which compounded their considerations, was that the percentage of LHA completion computed for the 77-1 Plan had been less than expected. To compensate for this lag in progress, the Navy should have withheld payments for approximately 20 weeks. The government's final choice was to continue with the Plan of Action, but also to offer to the contractor sufficient funds to assure continued production.

On 8 July, Litton informed Assistant Navy Secretary Bowers that they were cancelling their participation in the Plan of Action. Although the company intended to continue submitting claim packages, the Navy Claims Team broke off discussions with their corporate counterparts and deferred

planning for any provisional payments.

In light of the contractor's actions, a work stoppage appeared inevitable. In mid-July, the Justice Department filed a request for the Mississippi District Court to issue a restraining order which would have forced continuation of the LHA construction.

On 28 July 1976, District Judge Harold D. Cox issued a preliminary injunction which directed Litton to continue building the four remaining ships. The judge held that it was not the duty of the court to assess fault for the dispute between the parties, but that it was in the public interest to have these ships delivered without further delay. He ordered Ingalls to recall the termination notices which had been issued to 350 workers and to cancel notices intended for another 2700 employees. In return for continued performance, the Navy had to "advance and pay to the contractor on its requisition of the actual construction costs (labor and material) currently incurred in the manufacture and construction of general purpose amphibious assault ships 2, 3, 4 and 5" [3]. It was the judge's intention that the nine-month payment period (until April 1977) would have provided ample opportunity for determination of liability of the two parties in the claim dispute.

The wording in this decision was the subject of considerable misunderstanding when the payments finally began. The Navy paid the first invoice request on 11 August, but then challenged subsequent invoices on the grounds that the

court order had not intended the Navy to pay various overhead, fringe and administrative costs. The monthly DD payments exceeded costs by about \$2.3 million and the submarine repair contracts were showing some profit. Payment of 100% of the LHA costs would have resulted in a positive cash flow which was beyond the ostensible reason for the work halt. The Navy expected that an 86% of cost payment would have provided ample cash to the contractor and yet comply with the court order. Judge Cox ultimately clarified the situation when he directed the Navy to pay 91% of costs incurred.

At the time the injunction was invoked, Ingalls monthly total costs were about \$15 million; costs for labor and material averaged \$10.2 million of the total. The Project Manager had available \$163 million which would have provided full cost funding until June 1977. The Navy was obviously concerned with choosing a means by which performance could have been assured beyond that date. An appeal to Congress for additional appropriations without adequate justification would have probably met with stiff opposition. It was necessary to exhaust all available methods of securing voluntary performance from the shipbuilder. To establish the basis for a Congressional request, it would have been necessary to positively determine that it was beyond Litton's ability to further finance the LHA project.

In order to explore several alternatives simultaneously, the Navy instituted a dual approach to the complex ordeal. The preferred choice consisted of a continued effort to negotiate a settlement following the submission of the final claim

package in December. At the same time, the Navy prepared the data necessary to defend the case before the ASBCA. It was anticipated that Litton would appeal Navy proposal to that group. A mutual agreement on provisional payments or an ASBCA decision in Litton's favor would have provided the necessary reason for seeking additional funds from Congress.

The secondary effort was directed toward the District Court. The Navy sought a permanent injunction to follow the preliminary. With the issue of such a mandate, Litton would have been legally bound to complete the contract. In consideration of the magnitude of the claim, the court would have been inclined to direct the Navy to provide some additional reimbursement. This edict would have also required Congressional assistance.

Although the Navy was prepared to continue talks with the contractor, there was no progress toward any understanding. The contractor was recovering 91% of his booked costs so he had little incentive to pursue an immediate decision. The cost-type payments assured the Navy that the builder would continue work on the ships, but they created worries of a different nature. At the time that the payments began, Litton's underprogressed condition equated to a \$20 million overpayment. As a result of the continuing cost payments, it was estimated that this "debt" would have increased to \$90 million by the termination of the injunction. In the event that the judge ordered a return to progress payments, the liquidation of the excess payment could have proven devastating to the contractor.

Realizing that there was a very limited opportunity for a negotiated settlement, the government returned to the ASBCA on 3 January 1977 and requested a continuation of the LHA appeal proceedings. Deliberations of the claim had been suspended since January 1976 when the Plan of Action was formally initiated. In order to pursue the claim with the ASBCA, the Navy proposed to the District Court that the proceedings be suspended. On 19 April, the Court replied by extending the injunction to 31 October and ordering the Navy to continue the payments. Just prior to the Court's decision, Litton had filed suit in the U.S. Court of Claims to force the Navy to pay the \$13.6 million still owed on the May 1976 judgment for the SSN-680 claim. The validity of the supporting data had not been resolved in the courts; consequently, the Navy balked at releasing the remainder of the award.

Through the summer months of 1977, the Navy persisted in the effort to gain a judgment or a suspension from the District Court. The LHA Project Office was able to continue the payments only through the judicious use of money originally appropriated as claim settlement funds. Following the injunction extension ordered in April, the government had appealed to the Fifth Circuit Court of Appeals on the grounds that the District Court lacked the jurisdiction to force the Navy to pay the contractor for costs while the contract called for progress payments. While awaiting a decision by either of the legal forums, the Navy formulated no less than 14 alternatives to compensate for any contingencies expected to arise.

These plans included means of dealing with continued cost payments, progress payments, guaranteed loans, settlement of remaining portions of the LHA claim and conversion of the contract to a cost reimbursable basis. The common factors, which had to be considered in any choice, included the availability of funds needed by the government, the ability of the contractor to financially cope with a chosen payment method and the probability of the shipbuilder being motivated to bargain for a final solution.

In October, the District Court, as expected, again extended the injunction to expire on 31 July 1978. Litton had been reimbursed approximately \$134 million in excess of payments recoverable with a progress payment system. While the government continued its presentation to the higher court to have the payments halted, the Navy was deeply embroiled in negotiations with Litton officials. Assistant Secretary of the Navy (M,R&L) Hidalgo had been directed by Secretary Claytor to concentrate his efforts on a solution of all existing claims. In September, he had begun talks with Fred O'Green and one month later they reached an oral agreement by which the problem with Litton could be solved.

Litton had submitted the final documentation on their claim which had been increased by \$370 million to a total value well over \$1 billion. The Litton Claims Team supported by approximately 160 personnel was deeply involved in evaluating all counts within the claim. Mr. Hidalgo and Mr. O'Green mutually decided that the payments could be reduced to 75% of cost in return for the Navy's expedient processing of the claim.

In addition, the Secretary offered to hasten the release of funds being retained on the DD-963 contract. The slowly diminishing progress on that contract caused the payments to fall sufficiently below 105% of costs so that the retention release would not have violated the contractual ceiling. A third party to the pact, the Justice Department, agreed on 14 November to suspend the Court of Appeals action regarding the illegality of the cost payments [4]. The original three-way agreement called for the reduced payments to begin on 11 December and extend to 1 April 1978. Throughout the month of December, it became apparent that there was common ground for consideration and that a continued exchange of ideas might culminate in a final solution to the ongoing dispute. The stage was then set for an early January presentation to Congress on the Navy's intention to again concentrate on a bilateral agreement as allowed by PL 85-804. Following hearings in March 1978 and the expiration of the obligatory 60 day waiting period, the necessary modification was enacted on 13 April 1978 and the 75% payments were extended indefinitely.

In the interim, the ASBCA had reached a decision on the SUBSAFE issue which required the Navy to pay the shipbuilder \$50.4 million for a claim which had increased with interest to a final value of \$135.8 million. The Navy immediately paid \$31.3 million but protested the remainder. Finally in late May, the Navy agreed to pay the remaining \$19.1 million along with interest accrued since the decision.

Assistant Secretary Hidalgo continued bargaining with the contractor into the summer months. Litton had announced that their mid-year review revealed that the two contracts would suffer from eventual cost overruns of \$740 million (LHA-\$530M and DD-\$210M) [5]. The shipbuilder attributed the increases to higher labor rates, increased manhour estimates and subcontractor costs and financial recovery of claim litigation expenses. Nevertheless, the adversaries were closer to agreement that had been evident during the past six years of fruitless discussions. Each side had a considerable investment in the success of the deliberations and the ship production programs. Secretary Hidalgo had expressed to Congress his ambition for a negotiated resolution by mid-June.

1. Thornton, Charles B., Chairman of the Board, Litton Industries, Inc., Letter to Honorable William P. Clements, Jr., Deputy Secretary of Defense, 28 June 1976.
2. O'Green, Fred, President, Litton Industries, Inc., Letter to VADM R. C. Gooding, Commander, Naval Sea Systems Command, Subject: Notice of Intention to Discontinue Performance--Contract N00024-69-C-0283, 28 June 1976.
3. United States District Court of Mississippi, Judge's Opinion on U.S. vs Litton Systems, Inc., Et Al, Civil Action #S76-187(C), 28 July 1976.
4. Hidalgo, Edward, Assistant Secretary of the Navy for Manpower, Reserve Affairs and Logistics, Department of Defense Authorization for Appropriations For Fiscal Year 1979, Hearings before the Committee on Armed Forces, United States Senate, Ninety-Fifth Congress, Second Session on S. 2571, Part 5, p. 4103-4104, March 1978.
5. "Litton Unit Increases Cost Overrun Forecast on Two Navy Contracts," Wall Street Journal, p. 26, 2 February 1978.

H. PROPOSED SETTLEMENT

On the afternoon of 20 June 1978, word reached Pascagoula that a tentative settlement had been reached. Essentially, the two parties had agreed that Litton would absorb a fixed loss, the ceiling prices of both contracts would be raised and future payments would be computed on physical progress.

The Navy's bargaining position had been based on the results of a DCAA audit which projected that the two contracts would have cost \$647 million more than the amount to which the contractor was then entitled. This was further assessed as \$486 million on the LHA and \$161 million for the DD [1]. The independent accounting firm of Deloitte, Haskins & Sells confirmed that losses of that magnitude would have severely strained Litton's ability to generate necessary financing and would have placed them in violation of the loan covenants discussed previously. By the beginning of June, the contractor had been paid \$87 million above the contract ceiling, \$168 more than allowable with progress payments but \$146 less than had been expended. If the method of payments had reverted to a progress basis, the cash deficit would have reached almost \$381 by completion of ship production.

In April, the Litton Claims Team had reported to Assistant Secretary Hidalgo that of the existing \$1.093 billion claim, they had determined \$312 million to be valid. The contractor had previously received \$47 million in the form of a provisional payment and escalation adjustment. The remaining \$265 million would be paid in accordance with the progress payment system

outlined in the agreement. Litton would absorb \$200 million of the remaining loss with the Navy accepting the final \$182 million. The increase of the ceiling prices, with the updated computations of percentage completion, would result in a \$97 million payment due to the contractor on the effective date of the contract modification which occurs, at the end of the 60 day period, in mid-September.

It had been estimated that Litton will have incurred about \$115 million of unreimbursed costs by the effective settlement date. The \$97 million cash payment would reduce that to \$18 million which in turn lowers to \$182 million the amount of loss which will be charged against Litton through deductions from progress payments.

It has not been possible to determine the means by which the corporate negotiators agreed to the \$200 million loss. During past talks with Mr. O'Green and Mr. Thornton, Navy spokesmen had addressed the possibility of a fixed loss ranging from \$150 to \$250 million. During their analysis of the entire LHA claim package, the Claims Team concluded that the initial contract ceiling price had fallen \$330 million short of the minimum amount necessary to build five LHAs. A portion of this apparently unintentional underbid was compensated by the escalation provision. However, \$200 million of the final overrun was attributed to faulty pricing. Strict legal interpretation dictates that this cost, even though arising from an honest mistake, should be borne by the contractor and may have been the impetus for the final loss decision.

During a conversation with the author on 29 June, Captain Jones declined to elaborate on the specific aspects of the loss figure. In view of the business-sensitive and confidential nature of the deliberations just past, it was his respected opinion that the limits of the offer proposed by Litton should not be disclosed. He did indicate that their starting position included no loss for the corporation and adjustment to the ceiling price for the full amount of the claim. He also provided a final categorical breakdown of the claim and settlement. The figures quoted indicate adjustment to the ceiling price:

	CONTRACTOR	NAVY
Hardcore Claim	\$139.1M	\$ 38.6M
LHA Program Impact	\$425.6M	\$206.3M
DD Cross Impact	\$366.4M	\$ 32.4M
Interest and Profit	\$162.1M	\$ 16.6M
Cost of Litigation	N/A	\$ 18.1M
Less Amounts Previously Paid	<u>N/A</u>	<u>(47.2M)</u>
	\$1.0932B	\$264.8M

Under the provisions of the proposal, the combined EAC of both contracts would be \$4.726 billion. Subtracting the \$200 million loss, the ceiling price for the LHA is \$1.3 billion while the DD ceiling price is \$3.226 billion. If the future costs of construction exceed the EAC figure, the two parties will share equally up to \$100 million overrun. Any additional expenses, arising from events prior to the June date, will be borne by the contractor. In the event of completion at a

lower figure, Litton and the Navy will recoup the savings on an 80%/20% basis respectively. This share ratio provides a strong incentive for the shipbuilder to strive for cost efficiency. Additional provisions of the agreement include deletion of any liquidated damages due the Navy for late delivery, full release of all claims and actions arising from events occurring prior to 22 June 1978 including the SACAM and cancellation ceiling disputes and a release from government liability for MPD costs apportioned to the LHA and DD. At the time of the agreement, Litton stated these costs to be \$62 million [2]. The corporation does retain the option to possibly assess future contracts with the remaining \$71 million of the original \$133 million "start-up" costs allocated to military programs.

In contrast to a similar settlement with the Electric Boat Division of General Dynamics, the Ingalls compromise contained no specific provisions for inflation. There were approximately 24 months remaining until the completion of both ship programs; more than 90% of materials needed had been purchased and labor rates would remain stable throughout the remainder of the contract. Consequently, it was felt by both sides that any effects of inflation would be minimal and could be compensated for in the negotiated prices.

1. The Effect on Litton

In retrospect, the settlement, if approved by Congress, provides the only realistic solution to this complex and highly controversial conflict which had its origin over ten

years ago. In their third quarter FY 78 report to the stockholders, the Chairman and the President of Litton indicated that their acceptance of the offer had been undertaken with great reluctance. Despite whatever reservations they held while doing so, they admitted that it was in the best interests of the company, shareholders and employees. Even though they recorded a 32% increase in earnings over the three quarter period in FY 77, their year end report would show a loss due to the write-off of the entire \$200 million. They viewed it as an opportunity to start anew and apply all resources of the corporation to a broad-based profit growth [3].

Litton's FY 78 performance was announced in late August. The company reported fourth quarter operations' income of \$28.2 million bringing the year's total to \$82.1 million. This represented a 46.8% increase over 1977 income with a 6.1% increase in sales. However, a \$172.9 million write-off from the settlement of the claim brought the fourth quarter loss to \$144.7 million and the year-end loss to \$90.8 million. Included in this figure were currency losses of \$12.1 million. Board Chairman Thornton stated that, despite the losses on the two contracts, Litton operations in general "continue to improve" [4].

The spokesmen for both parties agreed that depending upon the litigative processes to settle the claim may have required an additional seven to ten years of entangled dealings. The legal bodies involved included the ASBCA, NCAB, Court of Claims, Federal District Court and the Fifth Circuit Court of Appeals. The level of effort necessary to satisfy

the demands of legal proceedings had been costly for both participants and had almost become superior in importance to construction of the ships.

The bilateral accord assures that the Navy will have the use of the full complement of complex warships initially ordered. Through the periods of negotiations during the past years, the Navy had considered delay or cancellation of some of the ships. Final analyses revealed that there would have been little cost savings or schedule improvement by doing so. Additionally, the increased fleet capabilities inherent in these 35 vessels were sorely needed. The delivery of the final ships will occur two years late for the DD and almost six years late for the LHA. The final estimated costs per ship would result in a 95% and 51% ceiling price increase for the LHA and destroyer respectively. Nevertheless, the Navy can now plan for the delivery and use of the ships.

Although the official implementation of the proposed settlement awaits Congressional approval (due mid-September 1978), NAVSEA personnel feel assured that it will be successfully executed. One remaining uncertainty is the future of the shipyard itself. On 24 March 1978, the yard was awarded a contract to build four advanced DD-993 for the Iranian Navy. These ships have expected delivery dates in the 1980-1981 time frame [5]. The facility is tentatively scheduled to construct one DD-997(H), a Spruance class destroyer capable of servicing V/STOL aircraft. Ingalls is one of two yards competing for the DDG-47 (a 963 hull and propulsion plant

equipped with AEGIS weapon system) production. Additional contracts for which the yard is expected to compete include the DDG-2 modernization, LSD-41 and FFG-7 production and possibly a sixth LHA. The East bank yard continues to overhaul nuclear submarines; due to the imminent decline in commercial shipbuilding, it is unlikely that Ingalls will benefit from that aspect of marine production. The automated yard is, by admission of most Navy and DOD leaders, a national asset. Unfortunately, the possibility of the yard being able to fully utilize its assembly-line capabilities is remote. With Ingalls competition facing a similar decline in demand for their facilities, it is expected that pricing competition will be quite keen. With the recent Presidential veto of the Defense Procurement Authorization Bill, the Navy's entire shipbuilding scheme could be in jeopardy. Overcapacity may now become Litton's prime adversary. There are simply no programs on the horizon which equal the magnitude of the LHA and DD-963 projects, which were intensely needed by both parties, but for which the Navy and the shipbuilder paid heavily.

1. Department of the Navy, Memorandum of Decision, Litton Industries, Inc., p. 2, 22 June 1978.
2. Ibid., p. 10-12.
3. Litton Industries, Inc., Report for the Nine Months ended 30 April 1978, 22 June 1978.
4. "Litton Industries Posts \$144.7M Fourth Quarter Loss," Wall Street Journal, p. 2, 1 September 1978.
5. Naval Sea Systems Command Report 250-574, Monthly Progress Report for Shipbuilding and Conversion, p. 7, 1 May 1978.

V. CONCLUSIONS/LESSONS LEARNED

It would be difficult to analyze the events comprising ten years of conflict between the Navy and a conglomerate the size of Litton Industries without formulating ideas on what could be done differently to avoid future recurrences of a similar nature. Government and industry leaders have contributed significantly to the incidence of written and spoken "exposes" of the shipbuilding claim problems and how they could have been avoided. The following represents this author's observations.

There are two contributing aspects to the Litton claim which may have been of less significance in the Navy's dealings with other yards. The Ingalls West bank facility is the first major shipyard built in the U.S.A. since WWII. This yard was planned and built concurrent with the development of the ships for which it was designed. The relatively new concept (for American shipbuilders) of building ships in a modularized format using an "assembly-line" process was introduced into the LHA/DD designs prior to its verification as a viable construction alternative. Although other yards, such as Avondale, now utilize a version of this concept, Ingalls was beset with a myriad of problems in pioneering its introduction into the U.S. A study by the Maritime Administration estimated "that the various assembly and subassembly areas are the equivalent of six conventional inclined ways in

terms of the numbers of ships that could be delivered annually" [1]. Nevertheless, the early delays encountered while trying to "de-bug" the facility contributed significantly to the cause of the claims and protracted negotiations associated with them.

In addition to the problems inherent in the use of an unproven construction style, Ingalls contracted to design and build sequentially two highly complex and extremely different classes of ships. It had been their intention that the first destroyer would be delivered approximately six months after the last amphibian. In fact, the DD-963 was delivered nearly nine months prior to LHA-1. This juxtaposition of the ship schedules resulted in the builder claiming appreciable impact of the delayed LHAs upon the destroyer program. Other shipbuilders have produced diverse vessels simultaneously; Newport News constructs submarines and aircraft carriers in their 260 acre South yard. It appears that highly sophisticated coordination is needed to move ship components successfully through the Ingalls five-bay erection area and into the integration area prior to launching. The early delay of the LHA necessitated having mixed ship components rescheduled and rerouted along the assembly path. This process was further complicated by having to funnel each ship into the proper position for movement onto the single launch pontoon.

As a result of the difficulties in the yard and the military spending constraints imposed by Congress and the Administration, it is doubtful that the Navy would again consider

contracting simultaneously for this many ships with the same builder. If such an opportunity arose, the costly lesson learned with Ingalls would provide ample reasons for the Congress and industry to thwart such a move. Few have forgotten the Navy's ill-fated cost efficiency defense for awarding the entire 30 ship DD contract to Litton/Ingalls.

It is not feasible for a shipbuilder to suspend ship construction during major yard improvements. It is conceivable that Navy contracts may be awarded to a builder who is in the midst of renovation. However, the experience at Pascagoula stresses the poor choice of depending upon a yard to produce a new class of ship in a facility utilizing untried procedures. There is no baseline with which intended production milestones can be compared; there are no reliable manpower estimates for the ship type or assembly process. The multitude of unknowns would severely tax the most competent management information team.

One might oppose such a cautious approach as being counter-productive to advancements in the industry, but the ultimate delivery of a ship following six years of delay could hardly speak well of expectations held early in the life of a new concept. The complex and intricate system integration inherent in modern warships does not allow them to be designed and built with anything short of a finely-tuned and well-monitored production process. Unfortunately, this was not available at Ingalls during the early years of the LHA and DD-963 programs.

Much has been written and spoken about difficulties arising from the use of Total Package Procurement with a FPIS contract. The contractor has consistently promoted conversion to a cost basis. In establishing a relationship with the shipbuilders, the Navy has two broad objectives: 1) to share the financial risks appropriate for the technical, scheduling and economic uncertainties and 2) to provide incentive for early production completion. The contract type chosen should promote these ideals.

The LHA and DD were the first ships to be built under the TPP concept. As early as July 1971, the Defense Department recognized the weaknesses in the system when DOD directive 5000.1 proposed that it not be used for future major weapon system acquisitions. Their decision was based on the uncertainties existing in a defense system which is contracted for before it is fully developed. This same doubt should have precluded the use of a FPIS contract. This style of fixed price procurement was used to allow the collection of adequate pricing information prior to the negotiation of firm price levels and schedules. In retrospect, if there was so little known about the design and costs of the two vessels, a cost type contract covering all ships might have more suitably fulfilled the contracting objectives. The government has been willing to admit its error of judgment in choosing the contractual vehicles and has been besieged to revert to a cost contract.

There are two points offered in defense of the Navy's refusal to do so. The contract originally used was valid and

mutually agreed upon. The Navy and the contractor have been in a deadlock for several years in their joint effort to assess fault for the numerous counts in the claim. The corporate leaders continually voiced their opinions that the Navy had a "duty" to fund their shortfalls. A basis for this attitude is seen in a comment offered by a former Litton executive who had responsibilities in the contracting area. He estimated that as a normal practice Litton, in the course of production and development, renegotiated its (government) contracts to one and a half times the original price--a nice margin for inept planning and mismanagement [2].

While the FPIS contract may have failed to compensate for unanticipated price increases, such as inflation and changes made after award, the weaknesses of contract management served to fuel an already volatile situation. A cost contract would have done little to encourage frugality on the part of Ingalls. Furthermore, it would have been unable to eliminate or even temper the damaging effects of the manpower shortage experienced in Mississippi. It is felt that had Ingalls better coordinated its design and production interface and more thoroughly studied the labor market, many of the delays, which were aggravated by FPIS, might have had far less impact. It is difficult to imagine how a different type of contract could have prevented the incidence of the early aerospace-vs-ship-building design disputes which rocked the company. These ships have been the victims of a dual-fault "accident"--the Navy for its choice of contract and decision to deviate from

the "hands-off" policy and the contractor for his inability to properly design and produce the vessels.

Another problem, which appeared to prolong the negotiations, was the absence of specifically designated government spokesmen. Over the course of years, Litton officials dealt with NAVMAT, NAVSEA, SUPSHIP, CNO, SECNAV, Assistant Navy Secretaries and the Deputy Secretary of Defense. It is highly improbable that the Navy could construct ships without collective inputs from all of these parties. However, the company approached these same individuals with pleas for claim settlement. A review of ten years of assorted public documents reveals the personalities and foibles of some of the Navy's negotiators. Each person (or group of persons) promoted his own ideals and solutions to the claim conflict as they had been nurtured by his organization. The association of such diverse and individually dynamic managers could not take place without minor conflict.

The contractor took full advantage of these differences of opinion to plead his case. In order to strengthen his bargaining position, he occasionally presented figures, such as a fixed loss amount, to his then present point of contact as having been offered by "another Navy source." One could hardly accuse the company of misrepresentation; the corporate leaders were simply taking advantage of a "best offer" situation. Following their discussions with one Navy channel, Litton spokesmen were prone to approach another channel with details of what had transpired. The second version was often

a subjective interpretation of the agreements made vice a verbatim recount of the incident. Consequently, misunderstandings were bound to develop among the government representatives. On one occasion, a Litton official, who was dissatisfied with a Navy solution, stated that he intended to approach the Commandant of the Marine Corps as he was "the real customer" for the amphibious ships.

Processing and settling claims have become almost as complex and time consuming as the preparation for the execution of the original contracts. Unfortunately, in some cases, the former endeavor has probably displaced the latter in perspective. Normal procedures dictate that a very limited number of government individuals conduct the actual negotiations for the initial contract. This theory of "controlled participation" should be extended to all confrontations with the contractors during the life of shipbuilding contracts. Presently, the contractors seem to have too many avenues of appeal for points with which they disagree.

If claims arise, a unified and comprehensive defense must be prepared and executed. A reasonable means of accomplishing such a goal requires that, at most, two individuals (a principal and a deputy) be designated to represent the government's case. It has been proposed that the leaders of the various branches responsible for ship construction be excluded from claim negotiations since those, who may have been responsible for claims arising, are then charged with solving the problem. This alternative may be slightly extreme in

nature, but it does stress a point. There should be strong consideration given to appointing a single source, such as the Claims Team, to conduct all dealings related to a claim. All inquiries from industry leaders would be referred to this group. These individuals must have authority commensurate with their responsibility and would have to rely heavily upon NAVSEA, NAVMAT, SUPSHIP, CNO, SECNAV, etc. for providing strong supporting evidence. The appointment of such a forum early in the LHA/DD dispute may have resulted in a more expedient solution which would have greatly benefited both parties.

The tribulations associated with the claims will have a lasting effect on the Navy and the private contractors. The Navy has since instituted revised procurement procedures with the FFG-7 program which will hopefully eliminate many of the conflicts which arose from the contracts of the early 1970s. It would be premature to believe that the claims are a feature entirely from the past. The long term nature of ship procurement combined with a constantly changing American economy results in a system which is highly susceptible to financial pitfalls. Learning from the LHA and DD-963 experience, the Navy has introduced contract covenants which more readily provide funding to the contractor.

In their attempt to improve the business relationship with the ship contractors, the Navy often finds itself under attack for "bailing out" the builders. The contractors often interpret the changes to be an admission of guilt for having

previously executed "unfair" contracts. Unfortunately, an allegation leveled in RAMPARTS ten years ago continues to inhibit the Navy's efforts today; "It is an unwritten law of the contract state that what the Navy brings to birth, it does not allow to die. The Navy will see that Litton, its answer to the decrepitude of the U. S. Maritime industry, is well taken care of" [3].

Litton's common complaint centered on their cash flow deficit. For many of the reasons previously discussed, it was due in part to their own internal weaknesses. The contracting procedures of the government, however, were not without blame. Any attempt to segregate the impact of the two becomes a subjective and highly emotional endeavor. It was, and remains, difficult to accurately evaluate the impact of the financial deficit upon the corporate structure. The company's obvious reluctance to open their books for government scrutiny leaves one with little choice but to focus on the more obvious impediments.

Increased lending requirements reported as a result of the claims would have inflated their interest expenses. The paucity of available cash could have prevented the company from taking advantage of more profitable investments. On the other hand, losses suffered in their other product areas leads one to believe that management expertise might have been just as deficient as cash. Nevertheless, the Navy has recognized the responsibility to more fully support its own programs, thereby removing a sufficient portion of past hardships from

its shipbuilders. It is felt that it will require three to five years to fully evaluate the effects of improved progress payment and escalation clauses, CPIF and FPI contracts for lead and follow ships respectively and increased awareness of causes and solutions to shipbuilding claims. This increased mutual understanding and sensitivity is necessary if the Navy is to enjoy continued availability of this critical defense resource through a period of imminent severe decline in utilization.

1. U. S. Department of Commerce, Maritime Administration, 1977 Report on Survey of U. S. Shipbuilding and Repair Facilities, p. 19, December 1977.
2. Horowitz, David and Erlich, Reese, "Big Brother as a Holding Company," Ramparts, p. 50, 30 November 1968.
3. Ibid., p. 52.

APPENDIX A

CHRONOLOGICAL LIST OF KEY DATES

- 1938 - Ingalls establishes yard at Pascagoula, Mississippi
- 1953 - Thornton & Ash acquire Electro-Dynamics
- 1954 - Name changed to Litton Industries
- 1961 - Litton acquires Ingalls
- 1967 - Litton announced as winner of competition for FDL construction
- 1968 - Construction of west bank yard begins. Ingalls awarded contract to build four ammunition ships, three nuclear submarines and seven merchant ships.
- 1969 - (May) Ingalls awarded LHA Contract (9 ships)
(June) Ingalls launches AUSTRAL ENVOY (first merchant built in new yard).
- 1970 - (June) Ingalls awarded DD-963 Contract (30 ships)
(November) Litton files \$31.5M claim against three nuclear submarines
(December) LHA production reduced to five ships
- 1971 - (April) Memorandum of Agreement executed
Litton files \$35.9M claim against ammunition ships
(May) Litton files \$101.3M SUBSAFE claim
- 1972 - (March) Litton submits LHA reset proposal containing 19½-24 months delay and \$246.6M claim
- 1973 - (February) Contracting Officer issues final decision on LHA. LHA delay 23½ months to 32 months.
(March) Mississippi District Court orders Navy to continue cost reimbursable payments. LHA claim raised to \$376M.
(October) Fifth Circuit Court of Appeals awards stay on lower court order. Navy allowed to stop cost type payments. 21 day deliberation period starts. Litton submits DD-963 reset proposal.
(November) Deliberation period ends.
- 1974 - (January) Litton predicts \$82M negative cash flow on LHA by contract completion.
(February) Progress payments on LHA begin
(March) Litton announces that DD program costs increased by \$350M with possibility of climbing another \$485M.

(September) Ammunition ship claim settled for \$18M
(December) LHA escalation payments completed

1975 - (January) Litton estimates \$189.4M negative cash flow by completion of LHA Contract.
(April) LHA claim increased to \$504.3M

1976 - (January) Plan of Action enacted (suspends ASBCA review of LHA claim)
(February) \$50M payment to Litton for principal on SACAM portion of LHA claim
(April) Deputy Secretary of Defense Clements announces intention to seek settlement with PL85-804.
(May) ASBCA awards Litton \$17.4M for nuclear submarine claim
(June) PL85-804 offer withdrawn. LHA claim increased to \$701.7M. Litton estimate final LHA cash flow deficit at \$407M and final DD deficit at \$40.6M. Litton announces intention to stop work on LHA on 1 August.
(July) District Court issues preliminary injunction ordering Litton to continue work and Navy to pay production costs (91% of booked cost) vice physical progress payments.

1977 - (April) Court extends injunction to 31 October
(September) LHA claim increased to \$1.08B.
(October) Court extends injunction to 31 July 1978
(December) Mutual agreement to reduce payments to 75% of booked costs and continue negotiations.

1978 - (February) ASBCA awards Litton \$50.4M on subsafe claim.
(April) PL85-804 modification enacted; 75% payment extended indefinitely.
(May) Litton estimates cost overruns will equal \$740M for both contracts.
(June) Agreement reached on proposed settlement utilizing PL85-804. Litton awarded \$312M on LHA claim.
(September) Expiration of 60 day waiting period

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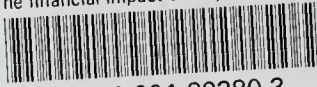
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